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EDITOR'S NOTE

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(13)

No. 86-251-ASX
Status: GRANTED

Title: Rockford Life Insurance Company, Appellant
v.
Illinois Department of Revenue, et al.

Docketed:
August 19, 1986

Court: Supreme Court of Illinois

Counsel for appellant: Griswold, Erwin N.

Counsel for appellee: Prorok, Charles J., Rosen, Patricia

Entry	Date	Note	Proceedings and Orders
1	Aug 19 1986	G	Statement as to jurisdiction filed.
3	Sep 17 1986		Order extending time to file response to jurisdictional statement until October 18, 1986.
4	Sep 17 1986		The above extension applies to all respondents.
5	Sep 19 1986		Motion of appellee Illinois ex rel. to dismiss or affirm filed.
6	Oct 22 1986		DISTRIBUTED. November 7, 1986
7	Oct 17 1986	X	Motion of appellee IL Dept. of Revenue to dismiss or affirm filed.
8	Nov 5 1986	X	Reply brief of appellant Rockford Life Ins. Co. filed.
9	Nov 10 1986		PROBABLE JURISDICTION NOTED.
			**
10	Dec 17 1986		Record filed.
11	Dec 23 1986		Joint appendix filed.
12	Dec 23 1986		Brief of appellant Rockford Life Ins. Co. filed.
14	Jan 16 1987		Order extending time to file brief of appellee on the merits until February 11, 1987.
15	Jan 28 1987		Brief of appellee Illinois ex rel. filed.
16	Feb 6 1987		SET FOR ARGUMENT. Tuesday, March 31, 1987. (4th case)
17	Feb 11 1987		Brief amicus curiae of United States filed.
18	Feb 11 1987		Brief amicus curiae of National Governors' Assn., et al. filed.
19	Feb 11 1987		Brief amicus curiae of CA Franchise Tax Board filed.
20	Feb 11 1987		Lodging received.
21	Feb 11 1987		Brief of appellees IL Dept. of Revenue, et al. filed.
22	Feb 17 1987		CIRCULATED.
23	Mar 11 1987	X	Reply brief of appellant Rockford Life Ins. Co. filed.
24	Mar 31 1987		ARGUED.

JURISDICTIONAL STATEMENT

86-251

No. 86-

In The

Supreme Court of the United States

October Term, 1986

Rockford Life Insurance Company,
Appellant,

v.

Department of Revenue of the State of Illinois, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

JURISDICTIONAL STATEMENT

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QUESTION PRESENTED

Whether the value of bonds of the Government National Mortgage Association ("GNMA"), carrying the unqualified pledge of the faith and credit of the United States, can properly be included in the measure of a state property tax in view of 31 U.S.C. § 742, the Supremacy Clause, and the constitutional principle of intergovernmental tax immunities.

STATEMENT UNDER RULE 15.1

James B. Zagel was a party to the action in the court below in his capacity as Director of the Illinois Department of Revenue. Douglas R. Aurand appeared as Treasurer and Ex-Officio County Collector of Winnebago County, Illinois.

STATEMENT UNDER RULE 28.1

Rockford Life Insurance Company was a wholly owned subsidiary of Liberty National Life Insurance Company at the time the tax was assessed and litigation begun. Subsequently Rockford Life was sold to the Reliable Life Insurance Company, but Liberty National assumed the tax liability of Rockford Life and was given the right to continue this litigation in the name of Rockford. The parent of Liberty National Life Insurance Company is Torchmark Corporation in Birmingham, Alabama.

STATEMENT UNDER RULE 28.4

This appeal raises the question of the validity of an Illinois statute, as applied. Thus, 28 U.S.C. § 2403(b) may be applicable to this proceeding. A copy of this Jurisdictional Statement has been served on the Attorney General of Illinois.

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IN THE

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OCTOBER TERM, 1986

No. 86-

ROCKFORD LIFE INSURANCE COMPANY,
Appellant,

v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

JURISDICTIONAL STATEMENT

DECISIONS BELOW

The opinion of the Supreme Court of Illinois (App. 3a-14a), and its order denying a Petition for Rehearing (App. 15a) are reported in 492 N.E.2d 1278. The Opinion of the Appellate Court of Illinois, Second District (App. 16a-36a), is reported at 128 Ill. App. 3d 302, 470 N.E. 2d 596. The Trial Court's decisions (App. 38a-45a), entered June 19, 1983, are unreported.

JURISDICTION

The opinion and judgment of the Supreme Court of Illinois was entered on April 4, 1986. (App. 4a-15a) A Petition for Rehearing was denied June 2, 1986. (App. 16a) The notice of appeal was filed in the Supreme Court

of Illinois on August 13, 1986. (App. 1a) This appeal was docketed within 90 days from the date of the denial of the petition for rehearing by the Supreme Court of Illinois.

The jurisdiction of this Court rests on 28 U.S.C. § 1257(2). The validity of a state statute, as applied, has been drawn into question as being repugnant to the United States Constitution, and the statutes of the United States, and the statute has been found to be valid, as applied, by the highest court of the State.[1] A challenge to the constitutionality of a state statute as applied constitutes a challenge to the statute itself for purposes of 28 U.S.C. § 1257(2). *See Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 44-441 (1979); *Xerox Corp. v. County of Harris*, 459 U.S. 145, 149 (1982).

CONSTITUTIONAL PROVISIONS INVOLVED

The constitutional provisions involved are set forth in the Constitutional and Statutory Appendix, *infra* p. 21.

STATUTES INVOLVED

The statutes involved are set forth in the Constitutional and Statutory Appendix, *infra*, pp. 21-26.

STATEMENT

This is an appeal by Rockford Life Insurance Company (Rockford) challenging the constitutionality of an Illinois personal property tax levied on its capital stock for the

[1] The tax was assessed on personal property held by the taxpayer, including certain United States government obligations which Appellant claimed throughout the proceedings cannot be subject to tax under the Constitution and statute laws of the United States. The state statute at issue is the Illinois law imposing a personal property tax, Ill. Rev. Stat., 1977, Ch. 120, Sec. 499, and this is implicit in the reference in the opinions of the Illinois Supreme Court to the "personal property tax due" (App. 3a), and the court's conclusion that the bonds "were not exempt from State or local taxation." (App. 14a).

year 1978. Included in the measure of the tax were securities held by Rockford, valued at $47,349,431.21, issued under a program administered by the Government National Mortgage Association (GNMA), with a pledge of the full faith and credit of the United States. GNMA is a wholly owned government corporation in the Department of Housing and Urban Development. The Illinois courts rejected Rockford's argument that these securities could not be included in the value of its capital stock for purposes of computing the personal property tax.[2]

Rockford is an Illinois corporation. It is engaged in the business of selling, underwriting, and servicing insurance policies. As an integral part of its business, Rockford purchases and holds various investment securities. Among the securities it held as of April 1, 1978, were the bonds guaranteed by the Government National Mortgage Association, referred to above. When Rockford first purchased GNMA bonds, the Illinois Department of Local Government Affairs (the Department) treated them as exempt from the Illinois personal property tax. But on December 21, 1978, the Department changed its position and took the GNMA bonds into account in assessing the capital stock of Rockford at a value of $6,937,000 for the year 1978. Rockford requested a review of the assessment on the ground that the GNMA bonds were exempt from the tax as obligations of the United States. On December 21, 1979, the Department reaffirmed this assessment.

Rockford then filed a complaint for administrative review with the Circuit Court of the 17th Judicial Circuit, Winnebago County, Illinois. In the meantime, the Treas-

[2] In the Court below, relatively small amounts of two other groups of securities were involved, issued under the New Community Act of 1968, and the Merchant Marine Act of 1936, as amended. Although we do not agree with the decision of the court below on the taxability of these securities, no question concerning them is raised in this Court by this appeal.

urer and ex-officio Collector of Winnebago County (the "County Collector") filed suit against Rockford to collect the taxes alleged to be due. The two cases were heard together, and on June 10, 1983, the trial court entered an order affirming the Department's assessment and entering judgment in favor of the County Collector for $723,053.70, with costs. The Order and Judgment were affirmed by the Appellate Court of Illinois, Second District, on October 26, 1984.

Rockford then appealed to the Supreme Court of Illinois, arguing *inter alia* that inclusion of the value of the GNMA bonds in its property tax base was in violation of 31 U.S.C. § 742, the Supremacy Clause, and the constitutional doctrine of intergovernmental immunity from taxation. On April 4, 1986, the Illinois Supreme Court affirmed the decision below, explicitly rejecting Rockford's arguments based on Federal constitutional and statutory grounds. It then denied Rockford's Petition for Rehearing on June 2, 1986.

GROUNDS FOR PLENARY CONSIDERATION

The question presented is substantial.

I. The States may not impose a tax on obligations of the United States, and the instruments involved here are obligations of the United States.

Rockford relied upon 31 U.S.C. § 742 (now codified in slightly different form as 31 U.S.C. § 3124(a)), which provided that (emphasis supplied):

> Except as otherwise provided by law, all stocks, bonds, Treasury notes, *and other obligations of the United States*, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.[3]

This provision is derived from and expresses the long-established constitutional rule that Federal instrumentalities, including bonds and other securities and obligations, are immune from taxation by the States. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). This rule has been broadly construed to mean that the States may not impose taxes "which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *Smith v. Davis*, 323 U.S. 111, 117 (1944).

This Court has repeatedly held that States may not impose even nondiscriminatory taxes on federal obligations, either directly, or indirectly as part of a tax on the taxpayer's total property or assets. *See American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983); *Society for Savings v. Bowers*, 349 U.S. 143 (1955); *New Jersey Realty Title Ins. Co. v. Div. of Tax Appeals*, 338 U.S. 665 (1950); *Farmers and Mechanics Savings Bank v. Minnesota*, 232 U.S. 516 (1914); *In re Bank Tax Case*, 2 Wallace 200 (U.S. 1865); *People of State of New York ex rel. Bank of Commerce v. Commissioners of Taxes*, 2 Black 620 (U.S. 1863); *Weston v. City Council*, 2 Peters 449 (U.S. 1829). Since the tax in question is undoubtedly a personal property tax, its application to the GNMA certificates cannot be sustained unless those certificates are found not to be obligations of the United States exempt from State taxation under 31 U.S.C. § 742 and the constitution.[4]

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[3] The origin of 31 U.S.C. § 742 can be traced to the Act of June 30, 1864, 13 Stat. 218. *See Smith v. Davis*, 323 U.S. 111, 118 n.9 (1944). See also Act of February 25, 1862, c.33, § 2, 12 Stat. 345, 346, cited in *Bank v. Supervisors*, 7 Wallace 26, 31 (U.S. 1868).

[4] The State does not dispute that the tax in question, Ill. Rev. Stat., 1977, Ch. 120, Sec. 499, was a personal property tax. In

The Department contends that the bonds and certificates in question are not "obligations of the United States" within the meaning of the statute, because they were not directly issued by the United States and the United States is not, as they say, the primary obligor. This argument fails to recognize the actual legal obligation undertaken by the United States in the certificates in question. It also undercuts the clear purpose of Congress in enacting the statute, which was to use the credit of the United States in order to make mortage money more readily available for prospective home owners, and at lower interest rates.

The *only* obligation to the holders of the securities involved here is that undertaken by GNMA on behalf of the United States. The GNMA bonds involved here expressly provide (with an exception which is not relevant here [5]) that

> . . . this certificate does not constitute a liability of nor evidence any recourse against the issuer since it is based on and backed by the mortgages composing the above-referenced pool, and since recourse may be had to the Government National Mortgage

fact, the tax statute involved specifically exempts "property of the United States" from its coverage. *See* 1977 Ill. Rev. Stat., Ch. 120, Sec. 500.4. The Illinois courts have likewise recognized that the tax was a property tax and thus could not be imposed on obligations of the United States under the United States Constitution. *Federal Life Ins. Co. v. Dept. of Local Gov't Affairs*, 65 Ill.2d 320, 357 N.E.2d 1189 (1976). Thus, the only issue before this Court is whether GNMA certificates are obligations of the United States and therefore exempt from State taxation.

[5] The exception clause reads: "Except as hereinafter undertaken," which is then followed by the language quoted in the text above. The only obligation "hereinafter undertaken," is the certification by the "issuer" that "This certificate is legal and regular in all respects, and is duly and validly issued" under the federal statute, and that "no contract or other agreement . . . adversely affects the right of the holder . . . to receive the payments provided by the certificate."

> Association in the event of any failure of timely payment, as provided for in the guaranty appended hereto.

GNMA is a corporation wholly-owned by the United States. Section 804(b) of Pub. L. 90-448, the Housing and Urban Development Act of 1968, now codified as 12 U.S.C. § 1721(g), authorizes GNMA to administer a program that has come to be known as the "Mortgage-Backed Securities Program," which is designed to attract capital into the housing market. GNMA is authorized to issue securities "based on and backed by" a pool of mortgages guaranteed or insured by Federal agencies including the Federal Housing Administration, the Veterans' Administration, and the Farmers Home Administration. It is also permitted to authorize qualifying private parties to issue such securities. GNMA is authorized to guarantee the timely payment of principal and interest on these securities. This guarantee is backed by the full faith and credit of the United States.

Under the program, a participating private party, generally a financial institution, acquires a pool of federally guaranteed mortgages. It then takes the pool to GNMA which enters into a Guaranty Agreement, by which it guarantees payment of principal and interest of the securities to be issued. The financial institution, in turn, agrees with GNMA to collect and transmit the payments due and received on the mortgages. GNMA then prepares the GNMA bonds, and the financial institution sells them to the public.

The *only* signatory of the GNMA security is the GNMA; the so-called private "issuer" never signs or otherwise takes a general obligation on the certificate. As indicated above, each certificate states on its face that the security does "not constitute a liability of nor evidence any recourse against the issuer . . . ." Each certificate specifically provides that the sole recourse of the security-holder is against GNMA, not the "issuer". In-

deed, GNMA prepares and delivers the securities, and the procedures for registering transfers of the securities are the same as those required for other obligations of the United States.

Moreover, the "issuer" transfers all of its right, title, and interest in the mortgage pool to GNMA at the time it enters into the guaranty agreement. The only right it retains is the right to sell the securities to the public and service the mortgage pool. *See Consolidated Mortgage & Finance Corp. v. Landrieu*, 493 F. Supp. 1284, 1287 (D.D.C. 1980); *New York Guardian Mortgagee Corp. v. Cleland*, 473 F. Supp. 422, 428-429 (S.D.N.Y. 1979). The "issuer's" compensation for divesting itself of the mortgage pool consists solely of the profits it makes on the sale of the mortgage-backed securities, and whatever income is derived from servicing the mortgages. *Id.*

In this situation, the only significant legal obligations on the bonds run between GNMA and the holders of the bonds. The private issuer in reality performs the function of a combination broker/servicing agent for GNMA. The obligation running from GNMA to the security holders is the same whether GNMA issues the certificates directly or issues them through a third-party private issuer. It is obvious that investors look to the credit of the United States, not that of the "issuer", in deciding whether to buy the securities.

For this reason, the Court in *New York Guardian*, 473 F. Supp. 422, 429-430, *supra*, emphasized the tenuous nature of the issuer's obligations with respect to the mortgage-backed securities in finding that the issuer's role was akin to that of a common law trustee:

> Most importantly, even in the case of modified pass-through securities the issuer is not personally liable either to the security holders or to GNMA for payments due but not collected provided it diligently performs its duties as issuer. . . . The issuer's only obligation runs to GNMA, see Guaranty Agreement § 4.03, and GNMA's only sanction is to terminate an issuer's status if payment is not made.

Therefore, the court held, the "issuer" was not an obligor or debtor, but served in a fiduciary capacity similar to a trustee.*

Thus, under the terms of the mortgage-backed securities, the so-called "issuer" is not an obligor. The only party with a general liability obligation to the holders is GNMA. The certificate thus embodies an "obligation of the United States," which brings it within the terms of 31 U.S.C. § 742. This provision was first enacted before mortgage-backed securities were developed, but it was clearly intended to protect "obligations of the United States" from the interference of State taxation.

II. The property tax involved here is imposed on values resulting from the unqualified guaranty of the Government and the carrying out of Government policies.

In enacting the legislation which authorized the mortgage-backed securities program, Congress was acting to advance the policies of the United States with respect to housing, a policy going back at least to "The Four Freedoms" expressed by President Franklin Roosevelt. This policy was adopted by Congress when it enacted 12 U.S.C. § 1716(a), which states that the purpose of the legislation, which includes GNMA, is to "provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." The Congressional goal of improving the nation's housing by attracting private capital into the housing market (thereby bringing down interest rates and making more money

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* *Cf.* Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-1 C.B. 8, both of which held that mortgage pools of participation certificates guaranteed by GNMA are treated as trusts for federal tax purposes.

available to individual homebuyers) was served in three respects: through the instrumentality of GNMA (1) investors would be insulated from problems inherent in the management of mortgage portfolios, (2) their mortgage investment would have enhanced liquidity, and (3) the full faith and credit of the United States would provide additional safety and security to the investors. *New York Guardian Mortgagee Corp. v. Cleland*, 473 F. Supp. 409, 411 (S.D.N.Y. 1979). *See also* Government National Mortgage Association Mortgage-Backed Securities Guide, Section 1-1:

> The Mortgage-Backed Securities Program provides a means for channeling funds from the Nation's securities markets into the housing market. *The United States Government full faith and credit guaranty of securities makes them widely accepted in those sectors of the capital markets that otherwise would not be likely to supply funds to the mortgage market.* The funds raised through the securities issued are used to make residential and other mortgage loans. Through this process, the program serves to increase the overall supply of credit available for housing and helps to assure that this credit is available at reasonable interest rates.

(emphasis supplied)

These purposes—encouraging capital investment in the housing market and assuring reasonable interest rates for such credit—are clearly important Government functions. Allowing the States to tax the mortgage-backed securities, either directly or indirectly, cannot fail to make the securities less attractive and result in higher interest rates. A tax by the states on the value of these securities would inevitably "diminish . . . the market value or investment attractiveness of obligations issued by the United States . . .", *Smith v. Davis*, *supra*, and therefore is invalid under the Constitution and under 31 U.S.C. § 742.

It is clear that GNMA bonds are literally "obligations of the United States," and thus within the provisions of 31 U.S.C. § 742. It is argued by the State that they are not issued in exercise of the "borrowing power of the United States." That may or may not be true—it is largely a matter of form, like the difference between a tax on A, and a tax on B measured by A. *Cf. Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929). But the GNMA bonds are clearly issued in pursuance of other federal powers, specifically the Commerce Clause and the power "to provide for the . . . general Welfare of the United States" under Article I, sec. 8 of the Constitution. See *Steward Machine Co. v. Davis*, 301 U.S. 548 (1973); *Helvering v. Davis*, 301 U.S. 619 (1937). At this date, it cannot be doubted that the Department of Housing and Urban Development is constitutional, and the Government National Mortgage Association is "in the Department of Housing and Urban Development" by legislative enactment.[7] As this Court said in *The Banks v. The Mayor*, 7 Wallace 16, 25 (U.S. 1868), "such certificates, issued as a means of executing constitutional powers of the government other than of borrowing money" are "as much beyond control and limitation by the States through taxation, as bonds or other obligations issued for loans of money." (Double negative eliminated.)

It is true that there is an underlying means for the payment of the income and principal of the bonds, that is, through the payments made by the mortgagors, funneled through the persons who packaged the mortgages. There would be a similar underlying means of payment if the government had borrowed the money directly and had channeled it to the loan market through brokers and bankers under appropriate contractual arrangements. In all situations, the government has many sources of funds to meet its obligations—taxation, rents, interest pay-

[7] Pub. L. 90-448, Title VIII, §§ 802(c)-(g), 82 Stat. 536, 537, 542; now found in 12 U.S.C. § 1717(a)(2)(A).

ments, sale of property, and so on. But the existence of methods of payment does not negate the basic and overriding obligation which the government has undertaken by its pledge to pay the interest and principal on the bonds.

The bonds here are issued as a means of carrying out government policy.[8] GNMA and the bonds are clearly instrumentalities of the federal government, designed to stimulate the economy and increase the commerce of the United States.[9] The bonds derive substantial value from

[8] The government's policy of using loan guarantees has been a great success. As long ago as 1966, "loans made through federal credit programs to domestic private borrowers amounted to 125 billion dollars. Guarantees and insured private loans were responsible for more than $91 billion of that amount; only a little more than $33 billion were in direct loans. *See* Floor debate on H.R. 14544, 89th Cong., 2d Sess., Cong. Rec., May 16, 1966, p. 10569." Brief for the State of Illinois in the court below, p. 14, n.5. The record in this case shows that in 1979 there was outstanding "approximately 65 billion dollars" in GNMA bonds. Testimony of William H. Ray, Jr., Senior Financial Vice-President and Treasurer of Liberty National Life Insurance Company, at Hearing in this case before the Illinois Department of Revenue, December 20, 1979, p. 29.

By the Act of May 2, 1986, 100 Stat. 412, Congress increased the limit on guaranty commitments by GNMA "by an additional $60,684,750,000 of principal." The Wall Street Journal reported this increase "boosting to 126 billion, GNMA's authority," saying that "Lower mortgage interest rates have created a rush of demand that initially depleted Ginnie Mae's guaranty authority for the current fiscal year, and has now created huge demand for the additional Ginnie Mae commitments." Wall Street Journal, May 15, 1986, p. 7.

[9] ". . . housing is one of the parts of our economy. And if you want to stimulate the economy, housing has been one of the areas that has been stimulated. Now, you could do this by having the Federal Government make direct financing available. But rather than use taxpayer money for it, the GNMA was one of the real beautiful devices that has come along to attract private capital but you use the Government's credit in order to make it credit worthy." Testimony of William H. Ray, Jr., at Hearing in this case before the Illinois Department of Revenue, December 20, 1979, p. 33.

the government's management and guarantee.[10] Consequently, the imposition of an *ad valorem* property tax by the State of Illinois on the *full* value of the bonds is at the very least a direct tax on that portion of the value attributable to (1) the government's guarantee, and (2) the simplicity and marketability resulting from the GNMA arrangement and administration.

The State of Illinois has made no effort to allocate its tax so as to exclude the tax on the portion of the value of the bonds which is the direct result of the government's guarantee.[11] Thus, the tax is a direct tax on an instrumentality of the United States, and on the carrying out of a governmental function by the United States. Since the bonds are issued to implement a policy of the federal governmental, the tax should be wholly invalid under the principles first discerned and enunciated in *McCulloch v. Maryland*, 4 Wheat. 316 (U.S. 1819), and strongly reaffirmed in *Smith v. Davis*, *supra*, 323 U.S. at 117, which

[10] "At the time we commit to buy GNMA's, we don't know who the issuer may be. Nobody does. You're buying it strictly on the basis that it is a government obligation." Testimony of William H. Ray, Jr., at Hearing in this case before the Illinois Department of Revenue, December 20, 1979, p. 30. "If GNMA's did not have a Government guaranty, then their prices would have to change in order to make them attractive investments. At the current price at which they trade in the market, the Government guaranty is essential to make them competitive." Testimony of Dexter E. Senft, Vice-President of First Boston Corp., at Hearing in this case before Illinois Department of Revenue, December 20, 1979, p. 65.

[11] In its brief before the court below, counsel for the tax collector of Winnebago County said (Br. p. 25):

> No attempt has been made by the State in the case at bar to assess a tax against the value of the Government's guarantee.

But this is clearly wrong. The entire value of the GNMA bonds was used in determining the amount of the tax, and this value clearly included a substantial amount which was derived directly from the Government guaranty, and the convenience resulting from its administration through the Government National Mortgage Association, in the Department of Housing and Urban Development.

held that States may not impose taxes "which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States. . . ."

III. The cases relied upon by the Illinois courts do not support the State's position.

The Supreme Court of Illinois attempted to avoid the conclusion that the GNMA certificates are not taxable, by seizing upon language contained in *Smith v. Davis, supra,* which refers to the "effort to secure necessary credit." It held that since the securities in question were not "related to the government's credit needs . . . [t]he government is not itself the borrower," and since the government "made the guarantees to induce others to invest in the securities . . .," the securities were not "other obligations of the United States" within the meaning of the statute. (App. 10a.) This attempted distinction is not adequate. First, as shown above in part I, the United States is in fact the true and only obligor on the certificates. And, as discussed in part II above, it is quite clear under the Constitution and prior decisions of this Court that the States may not impose taxes on any governmental function of the United States, whether or not that function is related to the borrowing power. *See The Banks v. The Mayor, supra.*[12] Thus, the attempt of the

[12] In that case, this Court held that interest bearing certificates of indebtedness issued to creditors for supplies were exempt from state taxation. "[S]uch certificates, issued as a means of executing constitutional powers of the government *other than of borrowing money* . . . [are] . . . as much beyond control and limitation by the States through taxation, as bonds or other obligations issued for loans of money." *Id.* at 25 (emphasis supplied). *Cf. Smith v. Davis, supra,* which implies that powers other than the borrowing power, e.g. the power "to secure aid from independent contractors for necessary military and civil construction projects," are also protected under the doctrine of intergovernmental tax immunity. 323 U.S. at 115. Unlike the situation in *Smith,* imposition of State taxes

Illinois Supreme Court to limit the Federal Government's immunity from State taxation to those cases in which the Federal Government is exercising its borrowing power for the purpose of acquiring cash is contrary to long-standing constitutional principles enunciated by this Court.

The Supreme Court of Illinois also relied on a supposed "four-part test" contained in *Smith, supra,* in holding that the GNMA certificates were taxable. *Smith* involved accounts receivable in the hands of contractors who had constructed two airports for the United States Army. This Court merely held that an open account claim against the United States for goods received and services rendered was not a "credit instrumentality" which would enjoy constitutional immunity from State taxation. As the Court noted, "the profits from a government contract stand in no preferred constitutional position so far as taxation is concerned." 323 U.S. at 116. In arriving at this conclusion, the Court stated that immune "credit instrumentalities" had historically shared four characteristics: (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates, and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay. The accounts receivable considered in *Smith,* by contrast, had none of these characteristics. But the Court did not state or even imply that these four characteristics must all be met before an obligation of the United States would be constitutionally immune from State taxation. It said only that none of the prior case law was "authority for placing an open account claim under the protective umbrella of constitutional immunity." *Id.* at 115.

That *Smith* did not state a determinative four-pronged test is strongly implied by decisions of this Court. *Mem-*

in this case will clearly interfere with important goals of the federal government such as stimulating the economy and ensuring the availability of funds and lower interest rates for borrowers.

phis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983), while citing *Smith* for the general proposition that obligations of United States instrumentalities are equivalent to Treasury notes and bills under § 742, made no reference to the supposedly dispositive "four-part" *Smith* test. Indeed, footnote 5 of that decision clearly shows that the Court did not view *Smith* as stating a determinative four-part test. *Memphis Bank* concerned, in addition to Treasury notes and bills, obligations of Federal Credit Banks. *See* 459 U.S. at 395, n.4. This Court did not explicitly discuss the question whether these obligations were "other obligations" within the meaning of § 742, but since it applied § 742 in determining whether the franchise tax in question was nondiscriminatory, the Court must have concluded that these obligations were covered by § 742. This is significant because the obligations in question do not satisfy the supposed *Smith* test. For instance, the Federal Land Banks are cooperatively owned by their individual members. They issue and sell bonds to the general public. *These bonds are not in any way guaranteed by or backed by the faith and credit of the United States.* Therefore, they could not meet item 4 of the *Smith* test. The Court was specifically informed that the United States was not liable on these obligations. See Brief of Appellees Garner and Foster at 26-27. Nevertheless, *Memphis Bank* treated these obligations as obligations of the United States which were protected by § 742.[13]

[13] In an attempt to avoid the implications of this result, the courts below made two arguments. *First*, they said that the parties stipulated that these obligations were protected by § 742 and, therefore, that the issue was not before the Court. But the stipulation referred to at page 394 of the decision in no way stated that the obligations in question were exempt. Rather, the parties merely stipulated that Appellant's federal corporate income tax returns listed interest on the securities in question as "interest on obligations of the United States and U.S. instrumentalities," and set out the applicable amounts for each type of security. See Parties' Joint Appendix at 36a-41a. The parties made no stipulation as to the

But even if the supposed *Smith* test were accepted as controlling, the GNMA securities would satisfy its requirements. In contrast to the open accounts considered in that case, there is no basis to contend that the GNMA certificates do not meet at least three out of the four characteristics noted in *Smith*, since they are written instruments, bear interest, and are issued pursuant to a specific Congressional authorization which pledges the faith and credit of the United States. The Illinois courts, however, have suggested that, as the United States is acting as guarantor rather than issuer, it has not made a binding promise to pay specified sums at specified dates. As shown above, this argument ignores the actual relationship between the United States, the holders of the certificates, and the issuer, for the only legal claim of the holder is against the United States. That the United

legal characterization of these securities. At any rate, this would have been a stipulation of law which would not be binding on this Court. *See Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 114 (1939). *Second*, the courts below distinguish bonds issued by the Federal Farm Credit Banks because such bonds are specifically immunized from state taxation by separate federal statutes (see 12 U.S.C. § 2055, 2079, and 2134). This would be a telling point, except that this Court itself dismissed it. While noting that the separate statutory immunity existed, the Court made clear that it was relying on 31 U.S.C. § 742:

> We have no occasion to determine whether the immunity described in these provisions is broader than that otherwise provided by 31 U.S.C. § 742. We note, however, that for purposes of federal tax immunity, our cases have made no distinction between the obligations of the United States Treasury and the obligations of the Federal Credit Banks.

459 U.S. at 396, n.5. *See also Macallen Co.*, 279 U.S. at 623, 624, which held that the statutory immunity provided to Federal Farm Loan Bonds issued by Federal Land Banks was "superfluous" in light of the constitutional principles involved. The Federal Farm Loan Bonds concerned in that case were issued under authority of Pub. L. 64-158, 39 Stat. 360, 376, the predecessor of the statute considered in *Memphis Bank*.

States has provided a means to meet its obligation does not negate the fact that, though others have the underlying liability on the mortgages, the United States, and it alone, is liable to pay the interest and principal on the bonds. But even if one should assume *arguendo* that the GNMA certificates do not share this characteristic, that assumption does not require or even support a conclusion that they are subject to State taxation under *Smith*.

The Illinois Supreme Court chose to treat the statutory and constitutional arguments advanced by Rockford as overlapping. On that basis, it applied the four-part constitutional test which it claimed was required by *Smith* in construing 31 U.S.C. § 742, and this led the court to conclude that the GNMA securities were not immune from State taxation under that statute. But the supposed four-part *Smith* test, even if accepted as such, was discussed only in the constitutional portion of this Court's decision.[14] When the Court construed Section 742, it applied a different test, finding that the exemption from State tax should apply to "interest-bearing securities or obligations authorized by Congress, for the payment of which the credit and faith of the United States was pledged." 323 U.S. at 118. Clearly, the GNMA certi-

[14] While *Memphis Bank and Trust Co. v. Garner*, 459 U.S. 392, 397 (1983), does suggest that Section 742 is "principally" a restatement of constitutional doctrines, this is not definitive. *Smith* clearly treated the constitutional and statutory analyses as being distinct, though related. The *Memphis Bank* statement is not inconsistent with this approach. The statute is a reflection or embodiment of the Constitutional principles underlying *McCulloch* and its progeny; but nowhere is it suggested that the statute defines exclusively those obligations which may not be taxed, and in fact, prior decisions of this Court suggest that it does not. *See Macallen Co. v. Massachusetts*, 279 U.S. 620, 624 (1929) ("Of course, in respect of United States securities, the statutory exemption is superfluous."); *The Banks v. The Mayor*, *supra*. Certainly this Court's two-fold analysis in *Smith* would have been unnecessary if the statute did no more than restate the constitutional rule.

ficates meet this requirement, since they bear interest, were authorized by Congress, and are backed by the faith and credit of the United States. Thus, if the Illinois courts are indeed correct and the constitutional and statutory requirements are overlapping, it would seem that the requirements stated immediately above are in and of themselves sufficient to confer immunity, whether statutory or constitutional, without regard to the alleged four-part test.

Should there be any doubt about this conclusion, this Court reiterated its position on the next page of its opinion in *Smith*. Concerning various statutes granting immunity from State taxation to Federal obligations, the Court stated "[a]ll of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." 323 U.S. at 119. Congress by enacting 12 U.S.C. § 1721(g) found that issuance of the GNMA mortgage-backed securities was a proper function of the Federal Government, *i.e.*, stimulating commerce by encouraging private investment in the housing market, and thereby providing for the general welfare by making home ownership possible for more Americans. Thus, those securities clearly fall within the definition contained in *Smith*.

CONCLUSION

The tax involved here puts a substantial burden on Federal housing policy, and interferes with the Congressional purpose to attract private investors into the mortgage market. Specifically it means that less of the investment funds of insurance companies and other corporate investors will be available for the mortgage market. This case thus presents a substantial federal question, since it directly deals with an issue "touching the accommodation of state and federal interests under the Con-

stitution." *Kosydar v. National Cash Register Co.*, 417 U.S. 62, 65 (1974).

Probable jurisdiction should be noted.

Respectfully submitted,

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August, 1986

CONSTITUTIONAL AND STATUTORY APPENDIX

United States Constitution, art. I, §8

SECTION 8. The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

* * * *

To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;

* * * *

United States Constitution, art. VI

* * * *

This Constitution, and the laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

* * * *

Title 12, United States Code

§ 1716. Declaration of purposes of subchapter

The Congress declares that the purposes of this subchapter are to establish secondary market facilities for home mortgages, to provide that the operations thereof shall be financed by private capital to the maximum extent feasible, and to authorize such facilities to—

(a) provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby

improving the distribution of investment capital available for home mortgage financing;

(b) provide special assistance (when, and to the extent that, the President has determined that it is in the public interest (for the financing of (1) selected types of home mortgages (pending the establishment of their marketability) originated under special housing programs designed to provide housing of acceptable standards at full economic costs for segments of the national population which are unable to obtain adequate housing under established home financing programs, and (2) home mortgages generally as a means of retarding or stopping a decline in mortgage lending and home building activities which threatens materially the stability of a high level national economy; and

(c) manage and liquidate federally owned mortgage portfolios in an orderly manner, with a minimum of adverse effect upon the home mortgage market and minimum loss to the Federal Government.

§ 1716b. Partition of Federal National Mortgage Association into Federal National Mortgage Association and Government National Mortgage Association; assets and liabilities; operations

The purposes of this title include the partition of the Federal National Mortgage Association as heretofore existing into two separate and distinct corporations, each of which shall have continuity and corporate succession as a separated portion of the previously existing corporation. One of such corporations, to be known as Federal National Mortgage Association, will be a Government-sponsored private corporation, will retain the assets and liabilities of the previously existing corporation accounted

for under section 1719 of this title, and will continue to operate the secondary market operations authorized by such section 1719. The other, to be known as Government National Mortgage Association, will remain in the Government, will retain the assets and liabilities of the previously existing corporation accounted for under sections 1720 and 1721 of this title, and will continue to operate the special assistance functions and management and liquidating functions authorized by such sections 1720 and 1721.

§ 1717. Federal National Mortgage Association and Government National Mortgage Association

(a) Creation; succession; principal and other offices

(1) There is created a body corporate to be known as the "Federal National Mortgage Association", which shall be in the Department of Housing and Urban Development. The Association shall have succession until dissolved by Act of Congress. It shall maintain its principal office in the District of Columbia and shall be deemed, for purposes of venue in civil actions, to be a resident thereof. Agencies or offices may be established by the Association in such other place or places as it may deem necessary or appropriate in the conduct of its business.

(2) On September 1, 1968, the body corporate described in the foregoing paragraph shall cease to exist in that form and is hereby partitioned into two separate and distinct bodies corporate, each of which shall have continuity and corporate succession as a separated portion of the previously existing body corporate, as follows:

(A) One of such separated portions shall be a body corporate without capital stock to be known as Government National Mortgage Association (hereinafter referred to as the "As-

sociation"), which shall be in the Department of Housing and Urban Development and which shall retain the assets and liabilities acquired and incurred under sections 1720 and 1721 of this title prior to such date, including any and all liabilities incurred pursuant to subsection (c) of this section. The Association shall have succession until dissolved by Act of Congress. It shall maintain its principal office in the District of Columbia and shall be deemed, for purposes of venue in civil actions, to be a resident thereof. Agencies or offices may be established by the Association in such other place or places as it may deem necessary or appropriate in the conduct of its business.

* * * *

§ 1721. Management and liquidation functions of Government National Mortgage Association

* * * *

(g) Guarantee of principal and interest on trust certificates and other securities; fees and charges; subrogation; contract for extinguishment of right, title, or interest in mortgages; protection of interests; full faith and credit; commitments limited

(1) The Association is authorized, upon such terms and conditions as it may deem appropriate, to guarantee the timely payment of principal of and interest on such trust certificates or other securities as shall (i) be issued by the corporation under section 1719(d) of this title, or by any other issuer approved for the purposes of this subsection by the Association, and (ii) be based on and backed by a trust or pool composed of mortgages which are insured under this chapter or title V of the Housing Act of 1949 [42 U.S.C. 1471 et seq.], or which are

insured or guaranteed under the Servicemen's Readjustment Act of 1944 or chapter 37 of title 38, or which are guaranteed under title XIII of the Public Health Service Act [42 U.S.C. 300e et seq.]. The Association shall collect from the issuer a reasonable fee for any guaranty under this subsection and shall make such charges as it may determine to be reasonable for the analysis of any trust or other security arrangement proposed by the issuer. In the event the issuer is unable to make any payment of principal of or interest on any security guaranteed under this subsection, the Association shall make such payment as and when due in cash, and thereupon shall be subrogated fully to the rights satisfied by such payment. The Association is hereby empowered, in connection with any guaranty under this subsection, whether before or after any default, to provide by contract with the issuer for the extinguishment, upon default by the issuer, of any redemption, equitable, legal, or other right, title, or interest of the issuer in any mortgage or mortgages constituting the trust or pool against which the guaranteed securities are issued; and with respect to any issue of guaranteed securities, in the event of default and pursuant otherwise to the terms of the contract, the mortgages that constitute such trust or pool shall become the absolute property of the Association subject only to the unsatisfied rights of the holders of the securities based on and backed by such trust or pool. No State or local law, and no Federal law (except Federal law enacted expressly in limitation of this subsection after October 8, 1980), shall preclude or limit the exercise by the Association of (A) its power to contract with the issuer on the terms stated in the preceding sentence, (B) its rights to enforce any such contract with the issuer, or (C) its ownership rights, as provided in the preceding sentence, in the mortgages constitut-

ing the trust or pool against which the guaranteed securities are issued. The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty under this subsection. There shall be excluded from the total amounts set forth in subsection (c) of this section the amounts of any mortgages acquired by the Association as a result of its operations under this subsection.

* * * *

Title 31, United States Code

§ 742. **Exemption from taxation**

Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

(recodified as 31 U.S.C. § 3124(a))

APPENDIX

APPENDIX

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APPENDIX

IN THE SUPREME COURT OF ILLINOIS

No. 61116

Appeal from the Appellate Court of Illinois,
Second District
Nos. 83-626 and 83-627

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois corporation,
Plaintiff-Appellant,
v.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS
and JAMES B. ZAGEL, Its Director,
Defendants-Appellees.

PEOPLE OF THE STATE OF ILLINOIS
ex rel. DOUGLAS R. AURAND,
TREASURER and EX-OFFICIO COUNTY
COLLECTOR OF WINNEBAGO COUNTY, ILLINOIS,
Plaintiff-Appellees,
v.

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois corporation,
Defendant-Appellant.

There Heard on Appeal from the Circuit Court
of the 17th Judicial Circuit
Winnebago County, Illinois

NOTICE OF APPEAL TO THE
SUPREME COURT OF THE UNITED STATES

Rockford Life Insurance Company hereby gives notice of appeal to the Supreme Court of the United States

from the final judgment of the Supreme Court of Illinois, issued April 4, 1986, finding that the levy of an ad valorem property tax on the capital stock of Rockford Life Insurance Company, calculated by taking into account the value of certain securities held by Rockford Life Insurance Company which were obligations of the United States, was not proscribed by 31 U.S.C. § 742 (now recodified as 31 U.S.C. § 3124(a)), and the Supremacy Clause and the doctrine of intergovernmental immunities of the United States Constitution, and from the final order denying the Petition for Rehearing, filed June 2, 1986.

This appeal is taken pursuant to 28 U.S.C. § 1257(2).

Dated this 13th day of August, 1986.

ROCKFORD LIFE INSURANCE COMPANY,
by its attorneys

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and
SPAIN, GILLON, TATE, GROOMS & BLAN
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Docket No. 61116—Agenda 24—September 1985

ROCKFORD LIFE INSURANCE COMPANY,
Appellant,

v.

THE DEPARTMENT OF REVENUE *et al.*,
Appellees.

[Filed Apr. 4, 1986]

JUSTICE MILLER delivered the opinion of the court:

The Illinois Department of Local Government Affairs assessed the capital stock of the Rockford Life Insurance Company for the year 1978 at $6,937,000. Included in the Department's computation were certain obligations that had not been included in the assessment in previous years and that Rockford Life believed were exempt from State and local taxation. The company sought administrative review of the assessment. The circuit court of Winnebago County affirmed the assessment and, in a related proceeding brought by the Winnebago County treasurer, entered judgment against Rockford Life in the amount of $723,053.70, representing the amount of personal property tax due and interest on that sum. The appellate court affirmed both judgments in a consolidated appeal. (128 Ill. App. 3d 302.) We allowed Rockford Life's petition for leave to appeal (94 Ill. 2d R. 315(a)) and now affirm the judgment of the appellate court.

Rockford Life presents two arguments against the assessment made here. The company argues first that the securities in question were obligations of the Federal

government and therefore, under Federal law, were immune from State and local taxation. Alternatively, the company contends that the Department is estopped from making the 1978 assessment because in preceding years these or similar obligations were not included in the calculation of its capital stock; the company says that in planning its investments it relied on the Department's earlier practice.

I

The assessment of Rockford Life's capital stock was to be used by the county clerks in determining the amount of personal property tax payable by the company. *Ad valorem* property taxes were to be abolished on or before January 1, 1979 (Ill. Const. 1970, art. IX, sec. 5(c)), and the assessment for 1978 was to be the last for that purpose. The three general categories of securities in question here are mortgage-backed certificates guaranteed by the Government National Mortgage Association (see 12 U.S.C. sec. 1721(g) (1976)) (GNMA), obligations guaranteed under the New Communities Act of 1968 (see 42 U.S.C. sec. 3902 (1976)) or under the Urban Growth and New Community Development Act of 1970 (see 42 U.S.C. sec. 4514 (1976)), and ship financing bonds guaranteed under the Merchant Marine Act of 1936 (see 46 U.S.C. sec. 1273(a) (1976)).

The greatest part of Rockford Life's holdings in question here consisted of GNMA mortgage-backed securities. GNMA is a wholly owned government corporation, created in 1968 "to attract private capital into housing." (*New York Guardian Mortgage Corp. v. Cleland* (S.D. N.Y. 1979), 473 F. Supp. 409, 411.) Describing the oeration of the mortgage-backed securities program, the court there explained, "In connection with this program, GNMA was authorized to issue securities 'based on and backed by' a pool of mortgages guaranteed by one of several government agencies, * * * and to authorize qualifying private parties to issue such securities. *Id.* GNMA

was further authorized to guarantee with the full faith and credit of the United States the timely payment of principal and interest falling due on such securities. *Id.*" (473 F. Supp. 409, 411.) The court noted, "The general purpose of these provisions was to foster a secondary market for home mortgages by providing a safety and liquidity not available to those investing directly in mortgages and to insulate GNMA investors from problems inherent in the management of mortgage portfolios. [Citations.]" 473 F. Supp. 409, 411.

As the appellate court described them, the other obligations in question here reflect a similar intent to attract private money into the credit markets by providing for government guarantees of the obligations. (128 Ill. App. 3d 302, 308-09.) The appellate court found that these securities "all have certain characteristics in common: they are issued by private parties, guaranteed by the full faith and credit of the United States government, and the United States government receives the fee for the guarantees." (128 Ill. App. 3d 302, 309.) The appellate court held that the securities involved here were not immune from State or local taxation. This same result was reached in an earlier case, *Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, which also involved the inclusion of mortgage-backed GNMA securities in the assessment of an insurance company's capital stock.

The parties agree that the relevant Federal statutory provision regarding the immunity of Federal obligations from State and local taxation is the following:

> "[A]ll stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." (Pub. L. No. 86-346, 73 Stat. 622; see 31 U.S.C. sec. 742 (1976).)

In 1982, when title 31 of the United States Code was reformulated, the provision in question, generally referred to as section 3701, was replaced by section 3124(a) of title 31 without substance change (31 U.S.C. sec. 3124(a) (1982)). See *American Bank & Trust Co. v. Dallas County* (1983), 463 U.S. 855, 859 n.1, 77 L.Ed.2d 1072, 1076 n.1, 103 S.Ct. 3369, 3372 n.1.

The Supreme Court has described section 3701 "'as principally a restatement of the constitutional rule'" of the immunity of Federal obligations from taxation by States and their political subdivisions. (*First National Bank v. Bartow County Board of Tax Assessors* (1985), 470 U.S. ——, ——, 84 L.Ed.2d 535, 543, 105 S.Ct. 1516, 1522, quoting *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 74 L.Ed.2d 562, 567, 103 S.Ct. 692, 695.) The court explained the constitutional basis for the rule in *Society for Savings v. Bowers* (1955), 349 U.S. 143, 144, 99 L.Ed.2d 950, 955, 75 S.Ct. 607, 608:

> "In 1829 this Court decided in *Weston v. City Council of Charleston* [(1829), 27 U.S. (2 Pet.) 449, 7 L.Ed. 481], that obligations of the Federal Government are immune from state taxation. This rule, aimed at protecting the borrowing power of the United States from state encroachment, was derived from the 'Borrowing' and 'Supremacy' Clauses of the Constitution, and the constitutional doctrines announced in *McCulloch v. Maryland* [(1819), 17 U.S. (4 Wheat.) 316, L.Ed. 579]."

The required immunity has been recognized in the decisions of this court. See *Federal Life Insurance Co. v. De-*

partment of Local Government Affairs (1976), 65 Ill. 2d 320, 324; *Price Flavoring Extract Co. v. Lindheimer* (1938), 368 Ill. 450, 452; see also Ill. Rev. Stat. 1979, ch. 120, par. 500.4 (exempting from taxation "[p]roperty of the United States, except such property as the United States has permitted or may permit to be taxed").

In *Smith v. Davis* (1944), 323 U.S. 111, 89 L.Ed. 107, 65 S.Ct. 157, the court considered whether an open account, or account receivable, owed to a contractor by the Federal government could be included in the computation of State and local personal property taxes. In determining whehter the open account was constitutionally immune from taxation, the court first considered the nature of the claim and then described the characteristics of instrumentalities generally qualifying for exemption. The court said:

> "Such a unilateral, unliquidated creditor's claim, which by itself does not bind the United States and which in no way increases or affects the public debt, cannot be said to be a credit instrumentality of the United States for purposes of tax immunity.
>
> In these respects a mere open account claim differs vitally from the type of credit instrumentalities which this Court in the past has recognized as constitutionally exempt from state and local taxation. Such instrumentalities in each instance have been characterized by (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay." 323 U.S. 111, 114-15, 89 L.Ed. 107, 110-11, 65 S. Ct. 157, 159.

In *Smith* the court also considered, as an inquiry separate from the constitutional question, whether the open account was exempt from taxation under section 3701; at that

time the section provided only that "all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority." In rejecting the taxpayer's argument that the claim was statutorily exempt, the court in *Smith* said:

> "Section 3701 on its face applies only to written interest-bearing obligations issued pursuant to Congressional authorization. Stocks, bonds and Treasury notes are obviously of that nature. And, under the rule of *ejusdem generis*, it is reasonable to construe the general words 'other obligations,' which allegedly cover open accounts, as referring only to obligations or securities of the same type as those specifically enumerated. [Citations.] This interpretation is in accord with the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit. It is unnecessary to extend such tax exemption, at least through statutory interpretation, to non-interest-bearing claims or obligations which the United States does not use or need for credit purposes. Tax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under section 3701 is necessary under these circumstances." 323 U.S. 111, 116-17, 89 L. Ed. 107, 111-12, 65 S. Ct. 157, 160.

Although *Smith* considered the constitutional and statutory inquiries separately, the statute, as we have said, has been construed by the court as a restatement of the constitutional rule. Therefore, we believe that the separate standards described by the courts are, for our purposes here, overlapping and equally valid. Under the four-part constitutional test set out in *Smith*, the appellate court here concluded that the securities in question were

not exempt from State or local taxation. The appellate court believed that the securities did not satisfy the third criterion, a promise to pay specified sums at specified times. The Federal government's undertaking with respect to these various obligations is a guarantee of the payment of principal and interest. The obligation imposed by that is not certain; it may or may not arise, depending on whether a default occurs. Moreover, the securities in question here do not appear to be related to the government's credit needs. The government is not itself the borrower, and it has made the guarantees to induce others to invest in the securities. We do not believe that the securities represent "other obligations of the United States" within the meaning of Section 3701.

Moreover, Congress has the authority to provide for the exemption of these obligations but has not done so. Rather, it has provided only for the exemption of the association itself:

> "The Association [*i.e.*, GNMA], including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income, shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority, except that any real property of the Association shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed." 12 U.S.C. sec. 1723a(c)(1) (1976).

In contending for immunity of the types of obligations at issue here, Rockford Life would find support in the decision of the Supreme Court in *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 74 L. Ed. 562, 103 S. Ct. 692. In that case the court held that a tax imposed by the State of Tennessee on banks was discriminatory within the meaning of section 3701; in the computation

of the tax base the taxing statute included income earned from Federal obligations but excluded income earned from obligations of that State or its political subdivisions. (459 U.S. 392, 398-99, 74 L. Ed. 2d 562, 568, 103 S. Ct. 692, 696.) Reaching that conclusion, the court said that it did not need to consider whether the tax was in fact "a 'franchise or other nonproperty ta[x] in lieu thereof.'" 459 U.S. 392, 396 n.6, 74 L. Ed. 2d 562, 567 n.6, 103 S. Ct. 692, 695 n.6.

Rockford Life interprets the Supreme Court's decision in *Memphis Bank* as holding that the particular obligations involved in that case were in fact immune from State and local taxation. The company believes that the obligations at issue here are sufficiently similar to those in *Memphis Bank* that they too must be deemed exempt.

In *Memphis Bank* "[t]he parties stipulated that the amount of tax paid by appellant for the years 1977 and 1978 was based entirely on interest earned on various federal obligations, primarily notes and bills of the United States Treasury and obligations of Federal Credit Banks." (459 U.S. 392, 394-95, 74 L. Ed. 2d 562, 566, 103 S. Ct. 692, 694.) Elaborating on that information, the court explained in a footnote that the tax there "was also based in part on income from obligations of the Farmers Home Administration and the Federal National Mortgage Association." (459 U.S. 392, 395 n.4, 74 L. Ed. 2d 562, 566 n.4, 103 S. Ct. 692, 694 n.4.) The court recognized that Congress had expressed exempted obligations of the Farm Credit Banks from State and local taxation (see 12 U.S.C. secs. 2055, 2079, 2134 (1976)), observing that, "for purposes of federal tax immunity, our cases have made no distinction between the obligations of the United States Treasury and the obligations of the Federal Credit Banks. [Citations.]" 459 U.S. 392, 396 n.5, 74 L. Ed. 2d 562, 567 n.5, 103 S. Ct. 692, 695 n.5.

Rockford Life believes that its securities were materially similar to the Farm Credit Bank, Farmers Home Ad-

ministration, and Federal National Mortgage Association obligations held by the taxpayer in *Memphis Bank*, and the company would conclude that its securities were similarly exempt. We disagree with Rockford Life's broad interpretation of *Memphis Bank*, and we do not believe that that case is controlling here. Although it is true that the exception stated in the second sentence of section 3701, allowing "nondiscriminatory franchise or other nonproperty taxes in lieu thereof," would not need to come into play unless it were first resolved that the obligations in question were in fact "stocks, bonds, Treasury notes and other obligations of the United States," in *Memphis Bank* the initial inquiry into the nature of the obligations was satisfied by the parties' stipulation that the tax did indeed fall entirely on income from exempt obligations. The only remaining questions, then, were whether the tax was being imposed in a discriminatory manner and whether it was a "franchise or other nonproperty ta[x] in lieu thereof." As we have said, the court decided that the tax was being imposed discriminatorily, and therefore the type of the tax did not need to be determined. In *Memphis Bank* it was the parties' stipulation that made section 3701 applicable in the first instance, and we do not construe the case as holding that any particular type of security was tax exempt. As the court indicated, the bulk of the income there came from Treasury notes and bills and from Farm Credit obligations. Because we have determined that *Memphis Bank* does not control here, we need not address Rockford Life's additional argument comparing its obligations to those held by the taxpayer in *Memphis Bank*.

As further support for its argument that the obligations at issue here are exempt from State and local taxation, Rockford Life points to certain official statements made regarding the natures of the Federal guarantees. For example, with respect to the GNMAs, the company

cites an Attorney General opinion of May 15, 1970, by then Assistant Attorney General William H. Rehnquist, who wrote, "I conclude that the Association [*i.e.*, GNMA] is authorized to make the proposed guaranties and that those guaranties would constitute general obligations of the United States backed by its full faith and credit." Rockford Life cites similar evidence regarding the other obligations involved here. We do not interpret these statements as touching on the issue presented. Rather, the concerns expressed were centered on the question whether the particular obligations posed any credit risk. With a government guarantee of the payment of principal and interest, the credit risk of the securities was reduced considerably, which enhanced their attractiveness to the investment community.

For these reasons, then, we conclude that the securities in question here were not "other obligations of the United States" within the meaning of section 3701 and therefore were not exempt from State or local taxation The Department correctly included them in its assessment of the company's capital stock.

II.

Rockford Life makes the alternative argument that the Department is equitably estopped from including within the computation of the company's capital stock the obligations in question here. Rockford Life points to the Department's exemption of the same or similar securities in previous years, and the company argues that in building a portfolio of investments it justifiably relied on that past practice and accordingly invested in obligations that it believed would be deemed immune from State and local taxation. The appellate court rejected the estoppel argument, concluding that the company's reliance on the previous practice was not reasonable and that no fraud or injustice had occurred.

At the administrative hearing Rockford Life presented its capital stock returns for the four previous years. During that period the company held obligations identical or materially similar to the ones at issue here, and in each of those years the Department either made no assessment or, after final review, cancelled the assessment. Rockford Life contends that in structuring its investment portfolio it relied on the earlier determinations of tax immunity, and the company's intangible property tax returns for the four years preceding 1978 show that as the company's capital stock increased, it invested increasing amounts in these obligations.

The usual elements of estoppel—a party's reasonable and detrimental reliance on the words or conduct of another (*Dill v. Widman* (1952), 413 Ill. 448, 455-56)—must be supplemented here with the additional restriction that a public body will be estopped only when that is necessary to prevent fraud or injustice (*Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill. 2d 427, 448-49), and that is especially true when public revenues are involved (*People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.* (1973), 56 Ill. 2d 210, 220; *Austin Liquor Mart, Inc. v. Department of Revenue* (1972), 51 Ill. 2d 1, 4-5). This court previously had held that the State is not estopped from reexamining a taxpayer's liability even though the return for that period has been approved (*People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.* (1973), 56 Ill. 2d 210; *Austin Liquor Mart, Inc. v. Department of Revenue* (1972), 51 Ill. 2d 1), and the Department's change in policy here would not necessarily be more burdensome or unjust than a reexamination of taxpayer's returns. We do not believe that the circumstances here show that the company has suffered fraud or injustice.

Moreover, it is not clear that Rockford Life actually suffered any harm from the Department's change in policy. The detriment to Rockford Life in this case would be measured not simply by the amount of the company's ultimate tax liability but would depend also on the relative returns provided by the various investment alternatives. This became clear at the administrative hearing, during the testimony of the company's investment manager. In explaining the company's reliance on the Department's previous practice, Mr. Ray testified:

> "Now, had we known that there was going to be a change in the attitude toward GNMA's from prior years when there was—
>
> Q: When they were not taxed?
>
> A: When they were not taxed, then probably we would have had to buy U.S. Treasury, direct U.S. Treasury obligations.
>
> Q: Or some other investment?
>
> A: Or some other investment. But in so doing, if we had bought U.S. Treasury obligations, that would have brought less income to the company because the income from the U.S. Treasury is less than on a GNMA."

Thus, it is not clear that the company actually suffered any harm from investing in the higher yielding, taxable obligations rather than in the lower yielding, tax-immune Treasury obligations.

Therefore, we conclude that the obligations in question here were not exempt from State or local taxation, and that the Department was not estopped from including them here in Rockford Life's capital stock. For the reasons stated, the judgment of the appellate court is affirmed.

Judgment affirmed.

61116

ILLINOIS SUPREME COURT
JULEANN HORNYAK, CLERK
Supreme Court Building
Springfield, Ill. 82706
(217) 782-2035

June 2, 1986

Mr. John C. McCarthy
Williams & McCarthy
P.O. Box 219
Rockford, IL 61105

No. 61116—Rockford Life Insurance Company, etc., appellant, v. Department of Revenue of the State of Illinois, et al., etc., appellees. Appeal, Appellate Court, Second District.

The Supreme Court today *DENIED* the petition for rehearing in the above entitled cause.

The mandate of this Court will issue to the appropriate Appellate Court and/or Circuit Court or other agency on June 12, 1986.

IN THE APPELLATE COURT OF ILLINOIS
SECOND DISTRICT

Nos. 83-826, 83-627

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Plaintiff-Appellant,

v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS and JAMES B. ZAGEL,
Its Director,
Defendants-Appellees.

Appeal from the Circuit Court of the
17th Judicial Circuit,
Winnebago County, Illinois

PEOPLE OF THE STATE OF ILLINOIS
ex rel. DOUGLAS R. AURAND,
TREASURER and EX-OFFICIO COUNTY
COLLECTOR OF WINNEBAGO COUNTY, ILLINOIS,
Plaintiff-Appellee,

v.

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Defendant-Appellant.

Appeal from the Circuit Court of the
17th Judicial Circuit,
Winnebago County, Illinois

[Filed Oct. 26, 1984]

JUSTICE LINDBERG delivered the opinion of the court.

Plaintiff, Rockford Life Insurance Company (Rockford) appeals from an order of the circuit court of Winnebago County affirming the 1978 assessment of its capital stock by defendant-appellee, Department of Revenue (Department). Rockford also appeals from the order in the case consolidated with the instant appeal entering judgment against Rockford in the amount of $723,053.70 and costs. Rockford argues that certain of its securities (mortgage-backed securities of the Government National Mortgage Association (GNMA), and obligations issued pursuant to the New Communities Act (NCA), the New Community Development Act (NCDA), and the Merchant Marine Act (MMA)) improperly were included in the capital stock assessment because they are direct obligations of the United States immune from state taxation. Because we conclude the obligations at issue are not direct obligations issued by the Federal government, we affirm.

On December 21, 1978, the Illinois Department of Local Government Affairs assessed the capital stock of Rockford for the year 1978 at a value of $6,937,000. Review of the assessment was requested by Rockford, and on May 2, 1979, the Illinois Department of Local Government Affairs, by letter, confirmed the assessment. Rockford thereupon filed a complaint in the circuit court of Winnebago County, Illinois, pursuant to the Administrative Review Law (Ill. Rev. Stat. 1979, ch. 110, par. 264 *et seq.*). Following hearings on motions, the court ordered that the case be remanded to the Department of Local Government Affairs with instructions to formally notify Rockford of its decision in accordance with its rules. On October 29, 1979, the Department of Local Government Affairs served notice of its decision confirming the assessment. Pursuant to Rockford's request, the

Department of Revenue (as successor to the Department of Local Government Affairs) held a hearing on December 21, 1979. Following the hearing, the director of the Department affirmed the assessment.

The company thereafter filed its complaint seeking judicial review of the decision of the Department affirming the 1978 assessment and the Department filed the administrative record as its answer to the complaint. In the trial court, Rockford argued that: (1) since the three types of securities were exempt as U.S. obligations under the Constitution and statutes of the United States, their value could not be included in computing the capital stock assessment; and (2) the Department was estopped because of its exclusion of the securities in 1974 through 1978 from including these securities in the 1978 capital stock assessment. In a memorandum decision, the trial court affirmed the Department's ruling and entered the following findings: (1) the securities in question were not "obligations of the United States" under 31 U.S.C. § 742 (1976) and therefore were not constitutionally immune from state taxation; (2) the Department's erroneous inclusion of non-exempt property as exempt property in its property tax manual did not preclude subsequent correction of the error and taxation of the property; and (3) the necessary fraud or injustice required for the application of the doctrine of estoppel was not demonstrated by the erroneous ruling of the Department or its failure to assess taxable property in prior years. Rockford filed a timely appeal from the trial court order entered on June 10, 1983, affirming the Department assessment. This appeal solely concerns the capital stock assessment against Rockford for 1978 because the capital stock tax was abolished on January 1, 1979 by Article IX, section 5 of the Constitution of Illinois of 1970. Ill. Const. 1970, art. IX, section 5.

Rockford asserts that the Department is estopped from assessing the securities in question because of its previous

administrative determinations that the securities were exempt from state taxation. The doctrine of equitable estoppel is "the effect of the voluntary conduct of a party whereby he is precluded from asserting his rights which might otherwise have existed as against another party who has relied in good faith upon such conduct and has been led thereby to change his position for the worse." (*Tyska v. Board of Education* (1983), 117 Ill. App. 3d 917, 930, 453 N.E.2d 1344, 1355; *Kyker v. Kyker* (1983), 117 Ill. App. 3d 547, 453 N.E.2d 108.) The party claiming the estoppel must have relied upon the acts or representations of the other and have had no knowledge or convenient means of knowing the true facts. *Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill.2d 427, 447, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957.

The doctrine of estoppel can be applied against the State when acting in a governmental capacity only in the most compelling circumstances. (*Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill.2d 427, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957; *Tyska v. Board of Education* (1983), 117 Ill. App. 3d 917, 453 N.E.2d 1344; *see generally* Annot., 21 A.L.R.4th 573 (1983).) "[W]here public revenues are involved, public policy ordinarily forbids the application of estoppel to the State" and " '[t]he government is not estopped by previous acts or conduct of its agents with reference to the determination of tax liabilities or by failure to collect the tax, nor will the mistakes or misinformation of its officers estop it from collecting the tax'." (Citations omitted.) *Austin Liquor Mart, Inc. v. Dept. of Revenue* (1972), 51 Ill. 2d 1, 4-5.

While acknowledging the principle that a State will generally not be estopped from collecting a tax, Rockford argues this case presents extraordinary circumstances justifying application of the estoppel doctrine and relies upon *Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill.2d

427, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957, for support. In *Hickey*, a railroad maintained and improved large amounts of lakefront property for over 50 years. Refusing to recognize "a right in the State officially disclaimed [by the State] for half a century" (35 Ill.2d 427, 449), the supreme court held the State should be estopped from now asserting its interest in the subject property. The court in *Hickey* emphasized the railroad's reliance on the State's position:

> "Meanwhile, numerous other lake shore boundary line agreements have been consummated and confirmed, conveyances made, leases executed and options granted; proposals for lake shore development were agreed upon and accepted whereby substantial construction obligations were apportioned as between the city, Park Commissioners and the railroad in reliance upon the assumption that the railroad was the fee owner of the lands it occupied * * *." (35 Ill.2d 427, 450.)

Therefore, while the *Hickey* court reiterated that qualified immunity from the estoppel doctrine was enjoyed by the State, it held that under these "extraordinary circumstances", the State was estopped from asserting its latent title claim.

Rockford argues the circumstances here similarly are "extraordinary. In the case at bar, Rockford reported NCA obligations on its 1974 tax return which were initially assessed but were later ruled exempt by the Director. In 1975, Rockford reported NCA and GNMA obligations which were initially assessed, but were later deducted from its capital stock assessment. Rockford in its 1976 return reported MMA obligations in addition to the GNMA obligations which the Director initially assessed, but upon reconsideration exempted from the capital stock tax computation. In its 1977 return, Rockford reported additional GNMA and MMA obligations as deductions

which the Department allowed. In 1978, the Department reversed its prior position and decided that the GNMA, MMA, NCA and NCDA obligations were subject to the capital stock tax.

Rockford argues that these circumstances constitute appropriate grounds for estoppel and contends all of the elements of the doctrine are satisfied: (1) positive acts by the Departments; (2) justifiable reliance by Rockford upon these acts; (3) amounting to fraud and injustice. Rockford cites the regulations contained in the Department's manual and the approval of the exemption in the years 1974-77 as positive acts by the State. The Department counters that its exemptions of these securities at issue are less affirmative than were the actions of the State in *Austin Liquor Mart, Inc. v. Department of Revenue* (1972), 51 Ill.2d 1, where the Department accepted payment from the taxpayer of his assessment and then attempted to reopen the investigation concerning the period covered by the assessment. The Department also quotes supreme court language that "State inspectors perform[ing] the ministerial acts of computing the tax due under one particular formula does not estop the State from repudiating that formula." (*People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.* (1973), 56 Ill. 2d 210, 220.) Neverehtless, we conclude the approval of the exemption constitutes a positive act of the State.

Rockford also asserts it relied upon the exemption, planning its investment strategy on the assumption that the obligations would continue to be excluded from calculation of the capital stock tax. Rockford's additional purchases of the subject obligations in the years 1974 through 1977 arguably provide some evidence of reliance by Rockford on the acts of the Department. However, Rockford's reliance was not reasonable. The taxable nature of these securities was unclear during at least three of the four subject years. No court decision or legislative pronouncement had resolved the issue, and

therefore, Rockford's reliance on the inconsistent Department rulings was unjustified. This is especially true because unlike the 50-year time period in *Hickey*, here the Department had only exempted the obligations for four years prior to its decision to include them in the tax calculation. The Department also raises a persuasive public policy argument, stating that were this court to apply the estoppel doctrine on the basis of four years of inconsistent Department actions, an administrative agency considering a novel issue would be bound by its initial ruling and would be precluded from adopting a new policy or from correcting an erroneous construction of the applicable law.

While the absence of reasonable reliance is alone fatal to Rockford's estoppel claim, Rockford has also failed to establish fraud. Rockford's allegations of fraud are unpersuasive. Rockford cites the fact that the Department's policy change resulted in almost a $500,000 tax liability, but the magnitude of the tax does not establish the existence or absence of fraud. Additionally, Rockford states that the Department's delay in assessing the tax until the last year of the capital stock tax "raises the inference of a calculated plan to catch this taxpayer off-guard." This allegation, however, is unsupported. Any allegation that the Department was negligent also does not amount to fraud.

> "More importantly, perhaps, is the possibility that application of *laches* or estoppel doctrines may impair the functioning of the State in the discharge of its government functions, and that valuable public interests may be jeopardized or lost by the negligence, mistakes or inattention of public officials." (*Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill. 2d 427, 444-48, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957.)

In the absence of any proof that the Department's action constituted a fraud resulting in an injustice done to

Rockford, the State should not be estopped from including the subject obligations in Rockford's capital stock tax calculation for 1978.

Rockford next contends that the debt obligations here were improperly included in the capital assessment because they constitute property of the United States immune from state taxation.

A. GNMA OBLIGATIONS

GNMA is a government-sponsored private corporation which was created in 1968 out of and partitioned from the Federal National Mortgage Association (FNMA). Both FNMA and GNMA are authorized tc "purchase, service, sell, or otherwise deal in any mortages which are issued after [a variety of federal statutes]." (12 U.S.C. § 1717(b)(1) (1976).) GNMA's role is to implement the mortage-backed securities program. GNMA enters into "Guaranty Agreements" with private investors who assemble pools of mortages and issue them for public offering. The issuer retains title to the pool, but assigns its rights in the underlying mortgages to GNMA. *New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411, n.2.

The assignment remains unrecorded "unless the issuer defaults on payments to security holders and GNMA exercises its option to assume issuer responsibilities." (*New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 422, 428.) GNMA's guarantee of the issuer's mortgage pools, however, "will not bring about an increase in the government's total contingent liability * * * GNMA is authorized to collect a fee for its guarantee, and it is intended that this program will be fully self-supporting and will operate at no cost to the Government." 114 Cong. Rec. 15, 236 (1968) (remarks of Sen. Bennett).

The full faith and credit of the United States is pledged to the payment of all amounts which may be required to

be paid under the guarantee. (12 U.S.C. § 1721(g) (1976).) The purpose of FNMA and GNMA is "to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing * * *." 12 U.S.C. § 1716(a) (1976).

B. NCA AND NCDA OBLIGATIONS

The New Communities Act of 1968 (42 U.S.C. § 3901 (1976) *et seq.*) and the Urban Growth and New Community Development Act of 1970 (42 U.S.C. § 4501 (1976) *et seq.*) attempt to "facilitat[e] the enlistment of private capital in new community development" (42 U.S.C. § 3901 (1976)), and to provide for the development of a national urban growth policy and to encourage the "rational, orderly, efficient, and economic growth, development, and redevelopment of our States, metropolitan areas, cities, counties, towns, and communities * * *." (42 U.S.C. § 4501 (1976).) These Acts authorize the Secretary of Housing and Urban Development (HUD), in the case of the former Act, and the Secretary acting through the community development corporation, in the case of the latter enactment, to guarantee bonds, debentures, notes or other obligations of eligible new community developers as the means of carrying out their governmental purposes. (*See* 42 U.S.C. § 3902 (1976) and 42 U.S.C. § 4514 (1976).) The full faith and credit of the United States is pledged to the guarantee of the payment of such obligations. (42 U.S.C. § 3906(b) (1976) and 42 U.S.C. § 4514(b) (1976).) In return for the guarantee, the issuer pays to the Secretary a fee. 42 U.S.C. § 3905 (1976).

C. MMA OBLIGATIONS

The Merchant Marine Act of 1936 establishes a Federal Ship Financing Fund "to foster the development and encourage the maintenance of such a merchant marine."

(46 U.S.C. § 1101 (1976).) To that purpose, the Secretary of Commerce may authorize guarantees of principal and interest on bonds issued by private obligors. (46 U.S.C. § 1273(a) (1976).) The Secretary receives from the obligor a security interest, perfected only upon default. (46 U.S.C. § 1273(b) (1976).) The program, furthermore, is self-supporting. The obligor pays a fee to the Secretary. (46 U.S.C. § 1274(e) (1976).) The full faith and credit of the United States is pledged to the payment of these guarantees under 46 U.S.C. § 1273(d) (1976).

These debt securities all have certain characteristics in common: they are issued by private parties, guaranteed by the full faith and credit of the United States government, and the United States government receives the fee for the grantees. Since of these securities GNMA obligations have the most indicia of tax-exempt status and since the parties almost exclusively discuss GNMA obligations, the following analysis will refer solely to GNMA obligations even though the conclusions reached are equally applicable to MMA, NCA and NCDA obligations.

In support of its contention that the obligations here are tax exempt, Rockford advances constitutional and statutory arguments. The constitutional argument is based upon the doctrine of implied powers recognized in *M'Culloch v. State of Maryland* (1819), 17 U.S. (4 Wheat.) 316, 4 L.Ed. 579. Under the rule first announced in *M'Culloch*, all properties, functions and instrumentalities of the Federal government are immune from state and local taxation. (*Montgomery Ward Life Insurance Co. v. State Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 411 N.E.2d 973, citing *Smith v. Davis* (1944), 323 U.S. 111, 113, 89 L.Ed. 107, 110, 65 S.Ct. 157, 158-59.) In *M'Culloch*, the Supreme Court struck down on the authority of the Supremacy Clause a state tax on the national bank which the government had established.

> "The result is a conviction that the states have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations of the constitutioanl laws enacted by Congress to carry into execution the powers vested in the general government. This is, we think, the unavoidable consequence of that supremacy which the Constitution has declared." (17 U.S. (4 Wheat.) 316, 436, 4 L.Ed. 579, 609.)

The *M'Culloch* court, however, restricted the breadth of its holding:

> "This opinion does not deprive the states of any resource which they originally possessed. It does not extend to a tax paid by the real property of the bank, in common with other real property within the state, nor to a tax imposed on the interest which the citizens of Maryland may hold in this institution, in common with other property of the same description throughout the state." 17 U.S. (4 Wheat.) 316, 436, 4 L.Ed. 579, 609.

Congress had codified this constitutional immunity by exempting from state and local taxation certain written obligations. (*See* 31 U.S.C. § 742 (1976), now codified as 31 U.S.C.A. § 3124(a) (West Supp. 1983); *see Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 411 N.E.2d 973.) That section provided:

> "Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes

in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." (31 U.S.C. § 742 (1976).)

The Supreme Court recently stated that its previous decisions have treated section 742 principally as a restatement of the constitutional rule regarding the immunity of federal government property including bonds and other securities from taxation by the states. (*Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. —, —, 74 L.Ed.2d 562, 567, 103 S.Ct. 692, 696.) The basis of the statutory exemption is "the fact that a tax upon the obligations of the United States is virtually a tax upon the credit of the government, and upon its power to raise money for the purpose of carrying on its civil and military operations." (*Hibernia Savings & Loan Society v. San Francisco* (1906), 200 U.S. 310, 313, 50 L.Ed. 495, 496, 26 S.Ct. 265, 266.) Since the question whether the subject obligations are constitutionally immune from taxation or are exempt by 31 U.S.C. § 742 (1976), is answered by examining the nature of the government's undertaking in the certificates themselves (*Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 297, 411 N.E. 2d 973, 977; *see also Farmers & Traders State Bank v. Johnson* (1984), 121 Ill. App. 3d 43, 45, 458 N.E.2d 1365, 1367), and since section 742 is primarily a restatement of the constitutional rule, both the constitutional and statutory inquiries will be considered together.

The question thus presented, Rockford asserts, is whether the four debt obligations at issue here are constitutionally immune from the Illinois Capital Stock Tax or are "other obligations of the United States" exempt from state taxation under 31 U.S.C. § 742 (1976). The Supreme Court in *Smith v. Davis* (1944), 323 U.S. 111, 114-15, 89 L.Ed. 107, 110-11, 65 S.Ct. 157, 159, enumerated certain attributes of exemption obligations:

"(1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sum as specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay."

The court in *Montgomery Ward* applied the *Smith* criteria to GNMA obligations and determined that GNMA certificates "satisfy all of the above requirements except for 'a binding promise by the United States to pay specified sums at specified dates'." (89 Ill. App. 3d 292, 297, 411 N.E.2d 973, 976.) While recognizing that the certificates represent some sort of obligation of the United States, the *Montgomery Ward* court employed the *ejusdem generis* rule (rule of construction whereby general terms will be construed to include only things of same general class as those enumerated, Black's Law Dictionary 464 (5th ed. 1979)), and concluded that the term "other obligations" in section 742 did not include GNMA obligations in part because they are privately issued.

Rockford challenges the *Montgomery Ward* court's statement that "Ginnie Maes are issued by a private issuer and not the government * * *." (89 Ill. App. 3d 292, 298, 411 N.E.2d 973, 977.) Review of the GNMA mortgage-backed securities program described by the court in *New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411, however, makes clear that the issuer is a private entity.

"A financial institution or mortgage servicing company wishing to participate must assemble or acquire a pool of government insured or guaranteed mortgages. GNMA then enters into a standard form 'Guaranty Agreement' with the issuer (this Guaranty Agreement is set forth at Appendix 19 to the GNMA Mortgage Backed Securities Guide, GNMA

5500.1 Rev. 4 (hereafter referred to as 'GNMA Guide')), under which, *inter alia*, GNMA agrees to guarantee timely payments of principal and interest as required by the terms of the securities (Guaranty Agreement § 6.01), and the issuer agrees to remit in a timely manner all payments required by the terms of the securities. Guaranty Agreement § 4.01. Should the issuer fail to make timely payments as required, the security holder's sole recourse is against GNMA (*Id.* § 7.01). However, GNMA may treat the issuer's failure to make required payments as an event of default under the Guaranty Agreement (§ 8.01), and this provides GNMA with the option of extinguishing the issuer's interest in the pooled mortgages and becoming owner of those mortgages 'subject only to the unsatisfied rights of the holders of the securities. . . .' 12 U.S.C. § 1721(g) (1976); Guaranty Agreement § 8.05." (Footnote omitted.)

Additionally,, the issuer is named specifically on the GNMA certificate contained in the trial record as the issuer of the security. We therefore are unpersuaded by Rockford's contention that the *Montgomery Ward* court erred in concluding that GNMA certificates are issued by a private issuer.

Rockford also contests the *Montgomery Ward* court's statement that the "private issuer is primarily liable to make the monthly interest payment and ultimately repay the principal." (89 Ill. App. 3d 292, 298, 411 N.E.2d 973, 977.) Noting that the payments do not become an obligation of GNMA unless and until the issuer defaults, the *Montgomery Ward* court characterized that eventuality as "contingent and wholly speculative." (*Montgomery Ward.*) Rockford responds that in reality, the government and not the private issuer is primarily responsible because each certificate is signed only by GNMA and because both the GNMA guide and security certificate say GNMA and not the issuer is liable for the guarantee.

This statement concerning the guide and certificate is accurate because GNMA and not the issuer *guarantees* the obligation. This fact, however, does not make GNMA primarily liable as argued by Rockford. Rather, the issuer assumes primary responsibility for payments to the security holders. Also, as the Department points out, *New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411, cited by Rockford recognized that the assignment to GNMA of the issuer's rights and liabilities only occurs upon the issuer's default.

Rockford's depiction of the issuer as simply an agent of GNMA responsible merely for collecting and distributing funds is belied by the *Cleland* court's description of the issuer's duties concerning section 1721(g) modified pass-through mortgages which are the subject of this action.

> "Federal regulations establish two types of mortgage backed securities: 'straight pass-through' securities, which provide for the payment by the issuer to the security holders of 'principal and interest [generated by the underlying pool of mortgages] *as collected*' and 'modified pass-through' securities, which 'provide for such payment, *whether or not collected*, of both specified principal installments and a fixed rate of interest on the unpaid principal balance, with all prepayments being passed through to the holder.' 24 CFR § 390.5 (1978) (emphasis added)." (*New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411.)

Because the certificates here are modified pass-through securities, the issuer was responsible to make principal and interest payments to Rockford even if it had not yet received payments from the mortgagors. The existence of this obligation supports the *Montgomery Ward* court's conclusion that the issuer and not GNMA is pri-

marily liable for the principal and interest due on the certificates.

Rockford also challenges a finding of the *Montgomery Ward* court that the GNMA obligations "were not issued by a government agency to borrow money on the credit of the United States to finance an essential government function." (*Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 297, 411 N.E.2d 973, 977.) Rockford maintains on the authority of two Supreme Court decisions that the *Montgomery Ward* court erred in distinguishing GNMA obligations on this basis. In *People ex rel. The Bank of New York National Banking Association v. Hoffman* (1869), 74 U.S. (7 Wall.) 16, 19 L.Ed. 57, the court concluded that certificates of indebtedness issued by the Federal government to creditors in exchange for supplies were exempt from state taxation. The *Hoffman* court stated:

> "But we fail to perceive * * * that such certificates [certificates of indebtedness issued by the Federal government in exchange for goods or services], *issued* as a means of executing constitutional powers of the government other than of borrowing money are not as much beyond control and limitation by the States through taxation, as bonds or other obligations issued for loans of money." (Emphasis added.) (74 U.S. (7 Wall.) 16, 24, 19 L.Ed. 57, 60.)

Rockford emphasizes the language that the certificates were issued as a means of executing constitutional powers other than of borrowing money in an effort to discredit the *Montgomery Ward* court's finding that GNMA obligations were not issued by the government to borrow money. However, as the Treasurer points out, the court in *Hoffman* was discussing two types of debt instruments issued directly by the Federal government. The GNMA obligations here were not issued by the Federal government, but rather by private entities.

In the second case cited by Rockford, *Hibernia Savings & Loan Society v. San Francisco* (1906), 200 U.S. 310, 50 L.Ed. 495, 26 S.Ct. 265, the Supreme Court rejected the claim that checks issued in payment of interest accrued upon registered bonds of the United States were entitled to exemption from state taxation. Rockford relies upon *Hibernia* because that Court stated that the test for determining exemptions was whether the tax hindered the effective exercise of the government agent's function. The Department counters that the test articulated in *Hibernia* only applies to cases where the United States' obligations are at issue; otherwise, tax exemption would apply to any area in which the Federal government in some manner had acted. We are persuaded by the Department's argument that the scope of the *Hibernia* language is too broad to be useful as a test in the case at bar. Furthermore, even if the test were applicable, the effect of the capital stock tax does not "deprive * * * [the private corporations] of power to serve the government as they were intended to serve it * * *" (*Hibernia Savings & Loan Society v. San Francisco* (1906), 200 U.S. 310, 315, 50 L.Ed. 495, 497, 26 S.Ct. 265, 267), for Rockford has cited no evidence in the record that issuers have been unable to market these certificates because they are taxable by the States. Therefore, the government function test does not aid Rockford.

The next argument raised by Rockford is that the *Montgomery Ward* court erred in limiting the exempt status to direct obligations issued by the United States in which it alone makes a binding promise to pay. Instead, Rockford contends that section 742 should be construed broadly, and relies upon *Smith v. Davis* (1944), 323 U.S. 111, 89 L.Ed. 107, 65 S.Ct. 157, for support. In *Smith*, the Court held that the debt owed by the United States could be taxed by State officials because the debt did not constitute a credit instrumentality within the meaning of the constitutional immunity from state

taxation. Rockford recognizes the four incidents of credit instrumentalities previously discussed, but then cites the following language of the *Smith* court as the appropriate rule to apply to the instant facts:

> "All of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." (*Smith v. Davis* (1944), 323 U.S. 111, 119, 89 L.Ed. 107, 113, 65 S.Ct. 157, 161.)

Rockford argues that GNMA obligations serve the necessary government function of insuring adequate funding for home mortgages and that the tax exempt nature of the mortgage-backed securities is necessary to attract adequate capital. Rockford does not explain, however, why this test should be employed to the exclusion of the four criteria also enunciated by the *Smith* court. Furthermore, the above language requires that the certificate be an obligation of the United States. In contrast to the position advanced by Rockford, we conclude as did the court in *Montgomery Ward* that the obligations involved here are not direct obligations of the United States.

In further challenging the *Montgomery Ward* court's limitation of state tax exemption to direct and exclusive obligations of the Federal government, Rockford argues that to fall within the constitutional exemption, the obligation need not be directly issued by the United States government as long as the obligation is issued by an instrumentality of the government to carry out its governmental function or is guaranteed by the full faith and credit of the United States. Rockford places great emphasis on the Supreme Court's recent decision in *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. ——, 74 L.Ed.2d 562, 103 S.Ct. 692. There, a Tennessee statute authorized a tax on a bank's net earnings income

from Federal obligations and defined net earnings to include interest earned from obligations of the United States and its instrumentalities, but excluded interest on similar obligations of Tennessee and its political subdivisions. The Supreme Court held that the state bank tax violated the immunity enjoyed by United States obligations from state and local taxation. The *Memphis Bank* court noted that the disputed tax was based upon interest earned "on various federal obligations, primarily notes and bills of the U.S. Treasury and obligations of the Federal Credit Banks" (459 U.S. ——, ——, 74 L.Ed. 2d 562, 566, 103 S.Ct. 692, 695), and also noted in a footnote that FNMA obligations were held by the bank. (459 U.S. ——, —— n.4, 74 L.Ed.2d 562, 566 n.4, 103 S.Ct. 6992, 695 n.4.) This reference to FNMA obligations is the only one contained in the entire opinion. Therefore, we are more hesitant than is Rockford to interpret the *Memphis Bank* decision as holding that FNMA certificates are federal obligations exempt from State taxation under section 742.

Even if *Memphis Bank* holds that FNMA obligations are exempt, however, that decision did not involve GNMA certificates. As the *Montgomery Ward* court recognized, GNMA certificates issued pursuant to section 1721(g) are significantly different than are FNMA certificates.

> "In this regard the Ginnie Maes issued in the instant case under 12 U.S.C. § 1721(g) (1976) differ from Mortgage Participation Certificates issued under 12 U.S.C. § 1717(c) (1976) and the Fannie Maes issued under 12 U.S.C. § 1719(d) (1976). Under the latter two sections FNMA and GNMA issue the certificates and are directly liable for payment. By contrast, the instant guarantee of payment is truly an indirect and contingent obligation of the United States and does not exempt the Ginnie Maes from State taxation." (89 Ill. App. 3d 292, 299, 411 N.E. 2d 973, 978.)

The presence of both a private issuer and the indirect liability of GNMA distinguishes GNMA section 1721(g) certificates from those issued directly by FNMA and thus, *Memphis Bank* is not determinative of the case at bar. *Montgomery Ward* therefore is the only case directly on point and we find its reasoning persuasive.

Rockford also argues that the GNMA obligations are exempt from state taxation because GNMA is a federal instrumentality and cites *Rust v. Johnson* (9th Cir. 1979), 597 F.2d 174, *cert. denied*, 444 U.S. 964, 62 L. Ed.2d 376, 100 S.Ct. 450, which held that a city's foreclosure on property without providing for FNMA's interest in the property was an unconstitutional exercise of state power over property of the Federal Government in violation of the Supremacy Clause. Despite the *private ownership* of FNMA, the *Rust* court held that FNMA was a federal instrumentality and its interest in the property was "property of the United States." *Rust*, however, does not require the conclusion that GNMA securities are United States property. Unlike FNMA securities, GNMA securities are issued and serviced by private issuers. Therefore, even if GNMA is considered a federal instrumentality, the burden of the capital stock tax did not fall directly upon the instrumentality, but rather upon those who purchased the GNMA securities. This indirect burden on GNMA is insufficient to warrant state tax exemption.

> "A state tax is not within the inhibition of state taxation of federal instrumentalities unless it is in fact a tax directly upon the government instrumentality, or its effect is so direct as to constitute it a substantial, as distinguished from an indirect and remote, interference with the exercise of the governmental functions delegated to the federal instrumentalities." (71 Am. Jur. 2d *State and Local Taxation* § 224 (1973).)

As the tax does not fall directly upon any federal instrumentality and as Rockford has not demonstrated how inclusion of the privately-issued GNMA certificates in the capital stock tax calculation constitutes a substantial interference with the exercise of GNMA governmental functions, the certificates are not constitutionally or statutorily immune from state taxation.

Accordingly, we affirm the order of the district court of Winnebago County.

AFFIRMED.

SEIDENFELD, P.J., HOPF, J., concur.

UNITED STATES OF AMERICA

STATE OF ILLINOIS,)
APPELLATE COURT,) ss.
SECOND DISTRICT,)

I, LOREN J. STROTZ, Clerk of the Appellate Court, in and for said Second Judicial District of the State of Illinois, and the keeper of the Records and Seal thereof, do hereby certify that the foregoing is a true, full and complete copy of the decision of the said Appellate Court in the above entitled cause of record in my said office.

In TESTIMONY WHEREOF, I have set my hand and affixed the seal of the said Appellate Court, in Elgin, in said State, this 26th day of October, A.D. 1984.

/s/ Loren J. Strotz
Clerk Appellate Court
Second District

STATE OF ILLINOIS
IN THE CIRCUIT COURT
OF THE 17TH JUDICIAL DISTRICT
COUNTY OF WINNEBAGO

No. 80-TX-21

PEOPLE OF THE STATE OF ILLINOIS ex rel. DOUGLAS R. AURAND, COUNTY TREASURER and EX-OFFICIO COUNTY COLLECTOR OF WINNEBAGO COUNTY, ILLINOIS,
Plaintiff,

vs.

ROCKFORD LIFE INSURANCE COMPANY,
Defendant.

JUDGMENT ORDER

This cause coming on for hearing before the Court upon the Complaint of Plaintiff and upon the Answer of the Defendant Rockford Life Insurance Company, the parties having appeared by their respective attorneys, the Court having heard the arguments of counsel, and being fully advised in the premises;

NOW, THEREFORE, THE COURT FINDS as follows:

1. That it has jurisdiction of all parties to, and the subject matter of, the above entitled cause;

2. That all of the material allegations of the Complaint have been proved and the true, and the plaintiff is entitled to the relief prayed in the complaint;

3. The assessment, for purposes of the Illinois capital stock property tax, of debentures issued under the New Communities Act (42 U.S.C. § 2901 et seq.); the

United States Guaranteed Ship Financing Bonds; and the Mortgage Backed Certificates guaranteed by Government National Mortgage Association is not prohibited by the laws of the State of Illinois or the statutes or Constitution or laws of the United States; said obligations not being exempt from such taxation.

4. The Department of Revenue is not estopped to tax said securities after long standing prior determination of their exemption.

5. There is now due and owing by Defendant, Rockford Life Insurance Company, to Plaintiff, the sum of $456,184.06 as personal property taxes for the 1978 assessment year, plus interest and publication costs in the amount of $266,869.64.

WHEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED THAT:

1. Judgment be entered for Plaintiff and against the Defendant in the amount of $723,053.70 plus costs;

2. Execution shall stay pending appeal of this cause and Case No. 80-MR-26 pending in this Court with bond constituting the deposit of the sum equal to the judgment entered herein in an interest bearing escrow account to be established by the Defendant, with an Escrow Agent mutually agreed upon by the parties; interest which is earned on that escrow account shall be retained in the account; upon entry of final judgment on the final appeal in said causes, the Escrow Agent shall distribute the funds as follows:

(a) If Plaintiff shall be the ultimately prevailing party, Plaintiff shall receive the amounts deposited by Defendant in the Escrow Account and any interest earned thereon, up to the amount of statutory interest that would accrue on the unpaid judgment; any interest earned on the escrow account in excess of the statutory interest on judgments shall be returned to Defendant;

(b) If Defendant shall be the ultimately prevailing party, Defendant shall receive all amounts deposited in the Escrow Account and all interest earned by such account.

Dated: June 10, 1983

ENTER:

/s/ John E. Sype
Judge

APPROVED AS TO FORM:

/s/ James Rees
Attorney for Plaintiff

/s/ John C. McCarthy
Attorney for Defendant

STATE OF ILLINOIS
IN THE CIRCUIT COURT
OF THE SEVENTEENTH JUDICIAL CIRCUIT
COUNTY OF WINNEBAGO

No. 80-MR-26

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Plaintiff,
v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS
and JAMES B. ZAGEL, its Director,
Defendants.

JUDGMENT

This cause regularly coming on for hearing before the Court upon the Complaint of Plaintiff, Rockford Life Insurance Company, for review of a decision rendered by Defendant, Department of Revenue of the State of Illinois, in a certain proceeding pending before it entitled In The Matter Of: Rockford Life Insurance Company Docket No. I-18-78, and upon the Answer of said Defendant consisting of the transcript of the record of said proceeding; the parties having appeared by their respective attorneys; and the Court having examined said record, having heard arguments of counsel, and being fully advised in the premises;

NOW, THEREFORE, THE COURT FINDS as follows:

1. That the Government National Mortgage Association Securities, Ship Financing Bonds, and the New Community Debentures, owned by the Plaintiff, Rockford

Life Insurance Company, during 1378 were not exempt from State capital stock taxation under either the Federal or Illinois Constitutions and/or laws; and

2. That the assessment of those securities by the Illinois Department of Revenue for the 1978 tax year, as stated in its administrative decision, is lawful; and

3. That the Illinois Department of Revenue is not estopped from assessing or taxing said securities as a result of its earlier Rules or policy of exempting them.

WHEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the decision of the Director of the Illinois Department of Revenue affirming the 1978 assessment of the securities owned by the Plaintiff, Rockford Life Insurance Company, at $6,937,000, be and is hereby, wholly affirmed.

Dated this 10th day of June, 1983.

ENTER:

/s/ John E. Sype
Judge

Filed June 10, 1983

/s/ Ronald Kotche
Clerk

APPROVED AS TO FORM:

/s/ John R. Simpson
JOHN R. SIMPSON
For the Illinois Department
of Revenue

/s/ James Rees
For The County of
Winnebago, Illinois

/s/ John C. McCarthy
For Plaintiff

STATE OF ILLINOIS
IN THE CIRCUIT COURT
OF THE 17TH JUDICIAL CIRCUIT
COUNTY OF WINNEBAGO

No. 80-MR-26

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Plaintiff,

—vs—

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS
and JAMES B. ZAGEL, its Director,
Defendants.

[Filed May 6, 1983]

MEMORANDUM DECISION

NATURE OF THE CASE

Complaint for Administrative Review, by Rockford Life Insurance Company (Rockford Life) against the Department of Revenue of the State of Illinois and James B. Zagel, its director (the Department) to review the Decision of the Department affirming Rockford Life's state Capital Stock Tax assessment for 1978.

RELIEF SOUGHT

Rockford Life challenges the Department's inclusion of certain Government National Mortgage Association (GNMA) securities (GINNIE MAES) and other securi-

ties in the assessment of its capital stock, and asks the Court to declare such assessment to be illegal and void.

ISSUES

Rockford Life asserts that the Department is precluded from assessing the securities in question because:

1. The securities are constitutionally immune from taxation because they are ". . . obligations of the United States . . .".

2. The Department's own Rules preclude their taxation.

3. The Department is estopped to tax these Securities for 1978 after long-standing prior determination of their exemption.

OPINION

1. The securities in question are not "obligations of the United States" within the meaning of 31 U.S.C. 742 (1976) and therefore are not constitutionally immune from state tax. *MONTGOMERY WARD INS. V. DEPARTMENT OF GOVERNMENT AFFAIRS* (1980) 89 ILL. APP. 3d 292 @ 298.

2. Notwithstanding the apparent inclusion of such securities as ". . . not subject to assessment . . ." in the "Illinois Property Tax Manual" published by the Department, that administrative agency had power to issue only such rules and regulations as are authorized by statute, and such erroneous inclusion of non-exempt as exempt property is invalid and would not preclude subsequent correction of the error and taxation of the property. *MONTGOMERY WARD INSURANCE V. DEPARTMENT OF GOVERNMENT AFFAIRS*, supra @ 302.

3. The State is not immune from application of the doctrine of estoppel, especially in its proprietary capacity.

HICKEY V. ILLINOIS CENTRAL R.R. CO. (1966) 35 ILL. 2d 427. But a strong public policy exists against estopping the State in matters relating to the collection of taxes, and the State cannot be estopped in the exercise of its powers of taxation unless necessary to prevent fraud or injustice. *AUSTIN LIQUOR MART, INC. V. DEPARTMENT OF REVENUE* (1972) 51 ILL. 2d @ 5, 6. Such fraud or injustice is not demonstrated by the publication of an erroneous rule by the Department or the failure to assess taxable property in prior years.

CONCLUSION

The Complaint in Administrative Review is dismissed, the Department's final administrative decision is affirmed, and the cause is remanded to the Department for it's further proceeding.

Counsel for Defendants will prepare and submit an appropriate order for the Court's signature.

/s/ John E. Sype
Circuit Judge

May 6, 1983

MOTION

NO. 86-251

In The
SUPREME COURT OF THE UNITED STATES

October Term, 1986

ROCKFORD LIFE INSURANCE COMPANY,

Appellant,

v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS, et al.,

Appellees

ON APPEAL FROM THE SUPREME COURT OF ILLINOIS

MOTION TO DISMISS OR AFFIRM

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1986

No. 86-251

ROCKFORD LIFE INSURANCE COMPANY,
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v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS, et al.,
Appellees.

ON APPEAL FROM THE SUPREME COURT OF ILLINOIS

MOTION TO DISMISS OR AFFIRM

Pursuant to Rule 16, this Motion to Dismiss or Affirm is filed on behalf of the Treasurer and Ex Officio Collector of Winnebago County (the "County Collector") who filed suit against Rockford Life Insurance Company (Rockford) to collect a personal property tax on the value of its capital stock alleged to be due.

The appeal presents no substantial Federal question. The securities involved are not obligations of the United States government and are therefore not entitled to immunity from taxation.

STATEMENT OF THE CASE

The facts of this case are stated fully in the statement of the case set forth in the jurisdictional statement.

ARGUMENT

INTRODUCTION

The doctrine of Federal immunity from State taxation is a "much litigated and often confused field." U.S. v. City of Detroit, 355 U.S. 466 (1958). Nowhere is that confusion more evident than in Rockford's characterization of GNMA certificates as "obligations" of the Federal government which are entitled to immunity from State taxation.

The doctrine of Federal immunity from State taxation is founded on the Supremacy Clause (Art. VI Constitution of the United States) as interpreted by McCullouch v. Maryland, 4 Wheat. 316 (1819) and has been codified by the Congress of the United States at 31 U.S.C. 742 (now codified as 31 U.S.C. 3124(a)). Rockford has invoked both the constitutional and statutory immunity as authority for its contention that the GNMA certificates are immune from the capital stock assessment and taxation.

As will be shown below, these contentions are frivolous and based upon Rockford's distorted view of the nature of the GNMA and its Mortgage-Backed Securities Program. Accordingly, plenary consideration of this case, by this Court is not warranted.

I.

THE SECURITIES INVOLVED HERE ARE NOT OBLIGATIONS OF THE UNITED STATES

Rockford relies heavily on 31 U.S.C. 742 which provided that: (emphasis added)

> Except as otherwise provided by law, all stocks, bonds, treasury notes, and other obligations of the United States, shall be exempt from taxation by or under state or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

The recognized purpose of this statute is to ". . . prevent taxes which would diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit" (emphasis added). Smith v. Davis, 323 U.S. 110,117 (1944). The Court in Smith recognized that not every "obligation of the United States," was of such dignity as to be provided with immunity from taxation. To hold otherwise would lead to the absurd conclusion that Federal Reserve Notes, which are defined as "obligations of the United States," 12 U.S.C. 411, are immune from taxation by the States. (See Provenza v. Comptroller of the Treasury, 497 A.2d 831 (M.D. App. 1985)). The instruments in question clearly do not, nor are they intended, to secure credit for the United States. Therefore it is clear that 31 U.S.C. 742 in its progeny protects only those obligations that were

issued to secure credit for the United States.

Rockford contends that when Congress created the Government National Mortgage Association, (GNMA), and provided for its "Mortgage-Backed Securities Program," its purpose was to ". . . use the credit of the United States in order to make mortgage money more readily available. . . ." (J.S. page 6) This contention ignores the clear purpose of Congress to provide for a secondary market for mortgages that "shall be financed by private capital to the maximum extent feasible, . . . " with, ". . . minimum loss to the Federal government." 12 U.S.C. 1716 (emphasis added).

In addition, the securities at issue are not even obligations of the United States, in the sense that they were not intended to have a financial impact on the Federal Treasury.

Rockford has consistently characterized the

debt-backed securities that are at issue as obligations of the United States so that they will fall within the penumbra of 31 U.S.C. 742. This approach is curious in that nowhere does Congress refer to the mortgage-backed securities as obligations of the Federal government. The only obligation, if you choose to characterize it as such, that is undertaken by the Federal government with respect to these securities, is the guarantee of timely payment of principal and interest. Rockford has seized upon this guarantee and characterized it as an obligation of the United States entitling the securities to immunity from taxation.

It might appear at first glance that the guarantee of the payment of the principal and interest is an obligation of the United States, but upon close inspection it is clearly evident that Congress made every effort to insulate the Federal Treasury from any

impact resulting from this guarantee.

In the first instance, the issuer enters into a guaranty agreement with the Government National Mortgage Association requiring it to make timely payments of principal and interest from the mortgages it holds in its pool. In the case of "modified pass-through" securities this guaranty agreement requires payment whether or not the issuer has collected on the underlying mortgages. (See New York Guardian Mortgage Corp. v. Cleland, 473 F.Supp. 409, 411 (S.D.N.Y. 1979)).

In addition, Congress provided that G.N.M.A. should charge fees for its services, with the objective that "all costs and expenses of its operation under this section should be within its income derived from its operation and that such operation should be fully self-supporting." 12 U.S.C. 1720. Congress also provided that GNMA, ". . . shall collect from the issuer a

reasonable fee for any guarantee under this subsection . . . ." 12 U.S.C. 1721 (g). The intent of Congress in providing for these fees, was clearly stated by Senatc Bennett during the floor debate on what was to become 12 U.S.C. 1721 (g) when he stated: "GNMA is authorized to collect a fee for its guarantee, and it is intended that this program will be fully self-supporting and will operate at no cost to the government." 114 Cong.Rec. 15236 (1968) (Emphasis added).

This Court has previously refused to consider a case concerning a guarantee almost identical to that at issue in this case. In S.S. Silberblatt, Inc. v. Tax Commissioner of the State of New York, 5 N.Y.2d 635, cert. denied 361 U.S. 912, (1959) the appellant was a private corporation that was financing a construction project for the construction of military housing. The financing for this project was funded by mortgages

guaranteed by the United States. When the plaintiff attempted to record the mortgages, a mortgage recording tax was assessed. The plaintiff sought a refund of that tax claiming that the mortgages were obligations of the United States. Finding that the mortgages were subject to the tax, the Court held that ". . . it is clear that the device employed was designated to relieve the government of its financially burdensome obligation to provide housing for its military personnel and at the same time avoiding increasing the national debt. It did not pledge its credit in the usual sense, but merely guaranteed each 'periodic payment' . . . ." S.S. Silberblatt, Inc. v. Tax Commissioner of the State of New York, 5 N.Y.2d 635, 637.

Rockford has continued to rely on this Court's decision in Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, (1983) as authority for the proposition that the

securities at issue are obligations of the United States. This reliance is misplaced. The sole issue before the Court in Memphis Bank was whether the Tennessee statute was a "nondiscriminatory franchise tax" which would place that tax within the exception provided for in 31 U.S.C. 742 allowing the obligations to be subject to taxation by the State. This Court's holding did not address the nature of the securities held by Memphis Bank because the parties not only stipulated that they were "federal obligations," but that the Bank's tax obligation would be zero if these federal obligations were excluded from computation of the tax. Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 394. Rockford attempts to play down this stipulation by claiming that it is in no way stated that the obligations were exempt from taxation. (J.S. page 16 footnote 13). However, by including in this stipulation

that by excluding the obligations in question from taxation, the tax liability of Memphis Bank would be zero, the parties clearly stated their belief that the obligations were exempt. That issue not being before the Court, this Court went on to determine whether the tax fell within the exception to 31 U.S.C. 742. Clearly this Court's decision in Memphis Bank & Trust Co. v. Garner is not dispositive of any issue before the Court in this case.

Therefore, the foregoing discussion makes it abundantly clear that when Congress created the Government National Mortgage Association and its Mortgage-Backed Securities Program, it intended to shift the burden of financing housing to private investors and not to raise money for that purpose on the credit of the United States. Consequently, the securities in question are not "obligations of the

United States" and are not entitled to immunity from taxation.

II.

SECURITIES INVOLVED ARE NOT CONSTITUTIONALLY IMMUNE FROM TAXATION.

Rockford rather adroitly attempts to argue that the tax immunity declared by the Constitution of the United States differs from that imposed by 31 U.S.C. 742.

Rockford contends that it is of no consequence that Government National Mortgage Association's bonds are not issued in exercise of the borrowing power of the United States because they are issued in pursuance of other federal powers. (J.S. page 11)

While it is true that the Federal government, in the exercise of its constitutional powers is "as much beyond the control and limitation by the state through

taxation as bonds or other obligations issued for loans of money," The Banks v. The Mayors, 7 Wallace 16, 25 (U.S. 1868), it does not follow that assessing an ad valorem tax on the value of GNMA bonds somehow infringes upon the operation of the Federal government. This Court has held that "immunity may not be conferred simply because the tax has an effect on the United States, or even because the Federal government shoulders the entire economic burden of the levy." United States v. New Mexico, 455 U.S. 720, 734 (1982).

It has been this Court's position that a private taxpayer may enjoy the Constitution's immunity guaranty only if that taxpayer is "so intimately connected with the exercise of a power or a performance of a duty" by the Federal government that subjecting it to taxation would be "'a direct interference with the function of government itself.'" James v. Dravo Contracting Co.

302 U.S. 134, 157 (1937). It can hardly be said that Rockford Life Insurance Co. "stands in the government's shoes" City of Detroit v. Murray Corp., 355 U.S. 495, 503, because it owns GNMA bonds.

It is Rockford's contention that the controlling issue is the effect taxation might have on the investment attractiveness of GNMA bonds. (J.S. page 10) However, Rockford offers no evidence that taxation would diminish the investment attractiveness of these securities or that the supposed tax exempt status has any impact on their marketability. By Rockford's own admission, it is the guarantee that makes these securities so marketable. (J.S. page 13, footnote 10). Cf. First National Bank of Atlanta v. Bartow County Board of Tax Assessors, et al., 470 U.S. _____, 84 L.Ed.2d 535, 545 (1985).

In any event, the debt-backed securities at

issue are not even arguably issued by the United States or any agency of the Federal government, they are issued by private companies. These securities are not issued to secure credit for the United States but are issued to remove a financial burden from the United States government and shift it to the private sector.

CONCLUSION

The debt-backed securities at issue are not issued by the United States government, backed by or for the credit of the United States government, therefore they are not constitutionally immune nor do they constitute "other obligations" contemplated by Congress as enacted in 31 U.S.C. 742. The only conclusion which can be reasonably drawn from the foregoing argument is that there is no basis upon which the Federal exemption can be claimed for the debt-backed securities at issue herein.

Wherefore, the County Collector, Appellee, respectfully submits that the questions upon which this cause depends are so insubstantial as to not need further argument, and the Appellee respectfully moves the Court to dismiss this appeal, or in the alternative, to affirm the judgment entered in the cause by the Supreme Court of the State of Illinois,

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Counsel for Appellee

September, 1986

MOTION

(3)

No. 86-251

Supreme Court, U.S.
FILED
OCT 17 1986
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

ROCKFORD LIFE INSURANCE COMPANY,

Appellant,

v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, et al.,

Appellees.

On Appeal From The Supreme Court Of Illinois

MOTION TO DISMISS OR AFFIRM

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

ROCKFORD LIFE INSURANCE COMPANY,

Appellant,

v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, et al.,

Appellees.

On Appeal From The Supreme Court Of Illinois

MOTION TO DISMISS OR AFFIRM

The Illinois Department of Revenue, an appellee in the above-entitled case, moves to dismiss this appeal or to affirm the judgment of the Illinois Supreme Court in this case on the grounds that the decision below correctly resolved the federal constitutional issue presented, so it should be affirmed; or, alternatively, the question presented is not substantial enough to merit further argument, so this appeal should be dismissed.

ARGUMENT

PRIVATELY ISSUED GNMA SECURITIES ARE NOT OBLIGATIONS OF THE FEDERAL GOVERNMENT WHICH ARE ENTITLED TO BE EXEMPT FROM STATE TAXATION.

The Federal National Mortgage Association was created in order to encourage investors to place their money in securities backed by residential mortgages, creating "secondary mortgage facilities for home mortgages." 12 U.S.C. § 1716. In 1968, in an effort to attract additional private capital into the housing market, Congress subdivided the former Federal National Mortgage Association into two "separate and distinct corporations"—the Federal National Mortgage Association (FNMA), a "government-sponsored private corporation," and the Government National Mortgage Association (GNMA), which remained part of the government. 12 U.S.C. §§ 1716(b), 1717(a). Congress authorized FNMA to issue securities based upon federally insured mortgages. 12 U.S.C. § 1719(d). FNMA securities are guaranteed by GNMA. *Id.* at § 1721(d).

In addition to the securities issued by FNMA, GNMA also insures privately-issued securities, such as the ones involved in the instant case, in order to implement the full Mortgage-Backed Securities Program ("MBS Program"). The privately-issued securities in the MBS Program are also to be backed by mortgages which are insured by various government agencies, such as the Federal Housing Administration, the Veterans' Administration, or the Farmers Home Administration. 12 U.S.C. § 1721(g); 24 C.F.R. § 390.1.

"The general purpose of these [insurance] provisions was to foster a secondary market for home mortgages by providing a safety and liquidity not available to those investing directly in mortgages and to insulate GNMA investors from problems inherent in the management of mortgage portfolios." (cits. omitted). *New York Guardian Mortgage Corp. v. Cleland*, 473 F. Supp. 409, 411 (S.D.N.Y. 1979). In order to accomplish these goals, GNMA enters into "Guaranty Agreements" with private investors (usually private banks) who assemble pools of federally-guaranteed mortgages and issue them for public offering. The issuer retains title to the pool, but assigns its rights in the underlying mortgages to GNMA. *Id.* at 411 n. 2, 428. This assignment remains unrecorded "unless the issuer defaults on payments to security holders and GNMA exercises its option to assume issuer responsibilities." *Id.* at 428.

GNMA will not guarantee securities if the pool arrangement proposed by the issuer does not satisfactorily provide for, *inter alia*, "[t]imely payment of principal and interest, in accordance with the terms of the guaranteed securities"; 24 C.F.R. § 390.10(c). Furthermore, GNMA will only take over primary responsibility of these insured mortgages if the issuer defaults on its obligations:

> Upon any default by the issuer and payment under its guaranty by the Association, or any failure of the issuer to comply with the terms of the guaranty agreement, the Association may institute a claim under the issuer's fidelity bond [*see* 24 C.F.R. § 390.11], or may, pursuant to section 306(g) of the National Housing Act, extinguish all the right, title, or other interest of the issuer in the pooled mortgages, . . . making the mortgages the absolute property of the Association, subject only to unsatisfied rights therein of the holders of the securities, . . .

24 C.F.R. § 390.13(b).

The issuer of GNMA-guaranteed securities also assumes a number of other responsibilities when it enters into a Guaranty Agreement with GNMA under the MBS Program. First, since the issuer has assembled the mortgages that back the securities, it warrants that those mortgages qualify for inclusion in the pool covered by the agreement; that is, it warrants that each of the mortgages is insured by an appropriate agency of the United States. *Consolidated Mortgage & Finance Corp. v. Landrieu*, 493 F. Supp. 1284, 1289 (D.C.D.C. 1980). Second, such a private issuer also "assumes not only the responsibility for risks customarily borne by a mortgage banker, but also assumes responsibility for the costs and risks of loss inherent in the administration of a GNMA-guaranteed mortgage portfolio" including, but not limited to " '(1) Disallowed foreclosure costs. (2) Loss of interest on foreclosure. (3) Loss of principal on foreclosure. (4) Catastrophic losses not normally covered by hazard and extended (insurance) coverage. (5) Losses arising from condemnation proceedings.' " (cit. omitted). *Id.* at 1290. Finally, an issuer who assumes the responsibility of servicing such a portfolio must also meet many additional requirements during the life of each mortgage pool, including the requirement that "[t]he issuer/servicer must correct defective mortgages, or, at GNMA's discretion, repurchase the defective mortgages from the pool at par." *Id.* From this discussion it is plain that the issuer of the securities is primarily responsible for them; the securities are simply guaranteed by GNMA.

Thus, the privately-issued securities insured by GNMA are not credit obligations of the federal government for two reasons—they are not unconditional promises to pay made by the government and these securities are not issued by the government in order to obtain credit. These

guaranties impose, at best, a contingent liability upon the United States government, so they are not "other obligations" of the United States within the meaning of 31 U.S.C. § 3124. This Court's decision in *Smith v. Davis*, 323 U.S. 111 (1944), expressly found that this phrase should not be interpreted to extend to "non-interest bearing claims or obligations which the United States does not use or need for credit purposes." *Id.* at 117. Since GNMA does not pay interest, either directly or indirectly, on these privately-issued securities (*see* 12 U.S.C. § 1721(g)) and since these securities are not issued to obtain credit* for the federal government, there is no statutory or constitutional reason to hold that these securities are immune from state taxation.

Following the rationale of this Court's *Smith* decision, in *S.S. Silberblatt, Inc. v. Tax Commission*, 5 N.Y.2d 635, 159 N.E.2d 195, *cert. denied*, 361 U.S. 912 (1959), the Court held that a New York mortgage recording tax could constitutionally be applied to federally-insured mortgages issued by corporations on land leased by the federal government in order to provide private financing for construction of a military housing project under the National Housing Act. As in this case, it was argued in *Silberblatt* that these mortgages constituted "other obligations" of the United States which were immune from state taxation. However, the New York Court rejected this argument, finding that the "device employed" by the federal

* The Secretary of the Treasury is authorized to raise money for the operation of the federal government under Title 31 of the United States Code by issuing the following types of obligations: bonds (§ 3102(a)); notes (§ 3103); certificates of indebtedness and Treasury bills (§ 3104); and savings bonds and certificates (§ 3105).

government was not a pledge of credit "in the usual sense"; it was merely a guaranty of private mortgage payments. 159 N.E.2d at 196-97. The same conclusion is mandated here, since the issuer of securities in the MBS Program is obligated to GNMA to assume the risk of loss associated with its management of the pool. It is only in the event of a default by the issuer that GNMA's guaranty will be activated and will impose a direct obligation on the federal government. Therefore, these securities are not credit obligations of the federal government and they should not be statutorily or constitutionally* exempt from taxation.

The appellant characterizes the distinction between instruments utilized to borrow money and those utilized for a different purpose as "largely a matter of form" (Jurisdictional Statement at 11), but this characterization is incorrect. This distinction is crucial to the purpose of the exemption, which was intended to prevent the states from impairing the power of the federal government to raise money to finance its operations by taxing instruments utilized to raise such revenue. Accordingly, instruments which are not utilized for credit purposes do not come within the purpose of this exemption. Appellant also suggests that any instruments which are issued in order to further federal policies should be exempt from state taxation (Jurisdictional Statement at 12), but such a broad and far-reaching interpretation of federal tax immunity has never been adopted by this Court and certainly can-

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* This Court has consistently viewed the statutory exemption as "principally a restatement of the constitutional rule." *First National Bank of Atlanta v. Bartow County Bd. of Tax Assessors*, ___ U.S. ___, 84 L.Ed.2d 535, 543 (1985).

not be supported by this Court's early decision in *The Banks v. The Mayor*, 74 U.S. (7 Wall.) 16 (1868), as appellant maintains. (Jurisdictional Statement at 11).

The certificates of indebtedness discussed in *The Banks* case were issued "in payment of supplies and in satisfaction of demands of public creditors," 74 U.S. at 25, and this Court found that these certificates were entitled to be tax-exempt because it "fail[ed] to perceive . . . that there is a solid distinction between certificates of indebtedness issued for money borrowed and given to creditors, and certificates of indebtedness issued directly to creditors in payment of their demands. . . ." *Id.* Since the certificates of indebtedness in *The Banks* case were issued to pay for supplies necessary to the war effort, they were just as immune from state taxation as if they had been issued to obtain money. In contrast, in the instant case the GNMA bonds were not issued by the federal government to obtain money, or supplies, or any other thing of value in order to operate the government, so they should not be considered credit instrumentalities entitled to a tax exemption. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 391, 396 (1983).

An investment opportunity is not exempt from state taxation merely because in the event of default the investment is guaranteed by the federal government. Nor is tax immunity required simply because the investment furthers important federal policies. For example, the Federal Home Loan Bank Board ("Board") is an agency of the federal government. *See* 12 U.S.C. § 1462. One purpose of the Board is to encourage local thrift and local home financing. *Id.* at 1465. In order to accomplish these goals, Congress has given the Board control of the Federal Savings and Loan Corporation ("FSLIC"), *id.* at §§ 1726(a)(2), 1728, which insures state savings and loan

institutions to increase the investment attractiveness of local savings accounts. Neither the federal guaranty nor the important federal policies involved mandates that such savings accounts cannot be subject to taxation by the states.

Taxation of state savings accounts insured by the FSLIC is constitutionally permissible because the savings accounts are not primarily the obligation of the federal government, nor are they utilized in order to obtain credit for the operation of the federal government. State savings accounts insured by the FSLIC are the primary obligation of the state thrift institution holding the deposits. Thus, the interest on these accounts can be taxed by the states without violating the doctrine of intergovernmental tax immunity. Similarly, there can be no objection to state taxation of GNMA securities.

Furthermore, it is unnecessary for the State to "allocate its tax so as to exclude the tax on the portion of the value of the bonds which is the direct result of the government's guarantee." (footnote omitted) (Jurisdictional Statement at 13). Even assuming, *arguendo*, that it were possible to place a monetary value on the government's guaranty of these securities, such an allocation is not appropriate. Allocation is only required when a portion of the assets of the entity being taxed is comprised of government obligations. *First Nat. Bank of Atlanta, supra*. As noted previously, in the instant case the federal government's guaranty does not convert these bonds into federal obligations, so allocation is unnecessary. The states are free to tax the full value of the GNMA bonds because these bonds are not credit obligations of the federal government.

The Illinois Supreme Court properly concluded that the only obligations which are immune from state taxation are

direct credit obligations issued by the federal government to obtain funds; sovereign tax immunity does not extend to obligations which are simply guaranteed by the United States. The obligations at issue in this case are not credit obligations, or even direct obligations, of the federal government. Therefore, as the Illinois Supreme Court concluded, they are not immune from taxation by the states. The decision of the Illinois Supreme Court in this case is correct and should be affirmed by this Court.

Alternatively, this Court should dismiss this appeal because a substantial federal question is not presented. This case involves an assessment of the capital stock of Rockford Life Insurance Company for the year 1978 at \$6,937,000, on which a tax became payable in the amount of \$469,871.58. (R. C38). The Illinois capital stock tax was abolished on January 1, 1979 by art. IX, § 5(c) of the 1970 Illinois Constitution, which provides that "[o]n or before January 1, 1979, the General Assembly by law shall abolish all ad valorem personal property taxes. . . ." Thus, with respect to the Illinois taxing scheme, the impact of this decision is neither far-reaching nor widespread because the tax at issue here was legislatively abolished seven years ago. Therefore, this Court should dismiss this appeal because a substantial federal question is not presented.

CONCLUSION

For the reasons stated above, the Illinois Department of Revenue asks this Court to affirm the decision of the

Illinois Supreme Court or, alternatively, to dismiss this appeal.

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REPLY BRIEF

No. 86-251

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

ROCKFORD LIFE INSURANCE COMPANY,
Appellant,
v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

APPELLANT'S BRIEF IN OPPOSITION TO APPELLEES' MOTIONS TO DISMISS OR AFFIRM

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1986

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v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

APPELLANT'S BRIEF IN OPPOSITION TO APPELLEES' MOTIONS TO DISMISS OR AFFIRM

Appellees' Motions to Dismiss or Affirm should be denied on the ground that substantial Federal questions are presented for review by this Court, as more specifically described in Appellant's Jurisdictional Statement. The arguments presented by Appellees, do not in any manner diminish the importance of the Federal questions presented here. Indeed, the arguments advanced by Appellees not only illustrate that this appeal presents substantial Federal questions, but support Appellant's position in this case.

Pages 2 and 3 of the Motion filed by the Illinois Department of Revenue set out in considerable detail the extensive Federal involvement with every phase of the mortgage-backed securities program under which the

GNMA certificates in question were issued. Appellee recognizes that the GNMA obligations concerned herein advance the goals of "foster[ing] a secondary market for home mortgages by providing a safety and liquidity not available to those investing directly in mortgages and . . . insulat[ing] GNMA investors from problems inherent in the management of mortgage portfolios." *New York Guardian Mortgagee Corp. v. Cleland*, 473 F. Supp. 409, 411 (S.D.N.Y. 1979), quoted at page 3 of Appellee's Motion. Appellee thus concedes that, as discussed more fully at pages 9-10 of the Jurisdictional Statement, these are important Federal Government policies and functions. Under the constitutional doctrine of intergovernmental immunities, such crucial functions cannot be interfered with by State taxation.

Nevertheless, Appellee argues that, because GNMA is acting "simply" as a guarantor, the certificates do not represent Federal "obligations" deserving the protection of 31 U.S.C. § 3124 or the Constitution. This is wrong for two reasons.

First, it misconstrues the nature of the obligation between GNMA and the holders of the certificates. GNMA is the only party with any obligation to the holders. The "issuer" is specifically released from any liability to make payments on the certificates. It is true that certain legal obligations run between the issuer and GNMA, but these are irrelevant to the question of who bears the obligation to the holders of the certificates. Thus, the statement contained at page 4 of Appellee's Motion, that the issuer is primarily responsible for the securities, is incorrect.[1] Also incorrect is the statement, at page 5 of

[1] This point also disposes of Appellee's attempt to compare GNMA certificates to the FSLIC insurance program, as Appellee concedes that the financial institution is primarily liable for the amounts on deposit. Moreover, the agreements in the FSLIC insurance program run between FSLIC and the institution; there is no agreement with the depositors comparable to GNMA's guarantee of timely payment of principal and interest.

Appellee's Motion, that GNMA does not pay interest, either directly or indirectly, on the certificates. 12 U.S.C. § 1721(g), cited by Appellee, clearly provides that the obligation of GNMA is for "timely payment of principal of and interest on such trust certificates or other securities . . . ."

Second, Appellee's argument is incorrect as a matter of law. The authorities cited cannot support Appellee's overly narrow construction of the statute and Constitution. Appellee evidently believes that, because the obligations concerned are arguably not undertaken in direct exercise of the Government's borrowing power, they cannot enjoy immunity from State taxation. But this reasoning rings hollow. Contrary to Appellee's reading of the holding of *The Banks v. The Mayor*, 7 Wallace 16, 25 (U.S. 1868), that case quite unequivocally states that obligations issued as a means of executing constitutional powers "other than of borrowing money" are just as immune from State taxation as bonds issued to obtain cash.

Further, as shown at pages 15 through 19 of the Jurisdictional Statement, *Smith v. Davis*, 323 U.S. 111 (1944), cannot bear the weight assigned to it by Appellee. Other decisions of this Court make it clear that *Smith* did not state a dispositive four-part test which must be met to qualify United States obligations for immunity from State taxes (*see, e.g., Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, nn. 4 and 5 (1983); *Macallen Co. v. Massachusetts*, 279 U.S. 620, 624 (1929)); and, as a factual matter, the certificates in question, which are publicly traded financial instruments, have no resemblance to the accounts receivable involved in *Smith*.

Finally, Appellee argues that no substantial Federal question is presented because the tax in question has been repealed. Obviously, the issues raised by this case involve far broader constitutional and statutory questions than the specific applicability of the Illinois property tax

to this Appellant, and raise fundamental questions concerning the accommodation of State and Federal interests. Moreover, the financial implications are also great. As of May 2, 1986, GNMA had authority to issue $126 billion in commitments; if this Appeal is dismissed, numerous states could feel free to tax this source of funds, severely hampering the Government's housing policy.

CONCLUSION

Appellees' Motion should be denied and probable jurisdiction should be noted in order that plenary consideration, on the basis of briefs and oral argument, may be given to the questions presented herein.

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November, 1986

JOINT APPENDIX

(5)

Supreme Court, U.S.
FILED
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No. 86-251

IN THE
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OCTOBER TERM, 1986

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Appellant,
v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

JOINT APPENDIX

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JURISDICTIONAL STATEMENT FILED AUGUST 19, 1986

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NOTICE OF APPEAL

IN THE SUPREME COURT OF ILLINOIS

No. 61116

Appeal from the Appellate Court of Illinois,
Second District
Nos. 83-626 and 83-627

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois corporation,
Plaintiff-Appellant,

v.

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS
and JAMES B. ZAGEL, Its Director,
Defendants-Appellees.

PEOPLE OF THE STATE OF ILLINOIS
ex rel. DOUGLAS R. AURAND,
TREASURER and EX-OFFICIO COUNTY
COLLECTOR OF WINNEBAGO COUNTY, ILLINOIS,
Plaintiff-Appellees,

v.

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois corporation,
Defendant-Appellant.

There Heard on Appeal from the Circuit Court
of the 17th Judicial Circuit
Winnebago County, Illinois

NOTICE OF APPEAL TO THE
SUPREME COURT OF THE UNITED STATES

Rockford Life Insurance Company hereby gives notice of appeal to the Supreme Court of the United States

from the final judgment of the Supreme Court of Illinois, issued April 4, 1986, finding that the levy of an ad valorem property tax on the capital stock of Rockford Life Insurance Company, calculated by taking into account the value of certain securities held by Rockford Life Insurance Company which were obligations of the United States, was not proscribed by 31 U.S.C. § 742 (now recodified as 31 U.S.C. § 3124(a)), and the Supremacy Clause and the doctrine of intergovernmental immunities of the United States Constitution, and from the final order denying the Petition for Rehearing, filed June 2, 1986.

This appeal is taken pursuant to 28 U.S.C. § 1257(2).

Dated this 13th day of August, 1986.

ROCKFORD LIFE INSURANCE
COMPANY,
by its attorneys

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and
SPAIN, GILLON, TATE,
GROOMS & BLAN
and
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directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." (Pub. L. No. 86-346, 73 Stat. 622; see 31 U.S.C. sec. 742 (1976).)

In 1982, when title 31 of the United States Code was reformulated, the provision in question, generally referred to as section 3701, was replaced by section 3124(a) of title 31 without substance change (31 U.S.C. sec. 3124(a) (1982)). See *American Bank & Trust Co. v. Dallas County* (1983), 463 U.S. 855, 859 n.1, 77 L.Ed.2d 1072, 1076 n.1, 103 S.Ct. 3369, 3372 n.1.

The Supreme Court has described section 3701 " 'as principally a restatement of the constitutional rule' " of the immunity of Federal obligations from taxation by States and their political subdivisions. (*First National Bank v. Bartow County Board of Tax Assessors* (1985), 470 U.S. ——, ——, 84 L.Ed.2d 535, 543, 105 S.Ct. 1516, 1522, quoting *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 74 L.Ed.2d 562, 567, 103 S.Ct. 692, 695.) The court explained the constitutional basis for the rule in *Society for Savings v. Bowers* (1955), 349 U.S. 143, 144, 99 L.Ed.2d 950, 955, 75 S.Ct. 607, 608:

> "In 1829 this Court decided in *Weston v. City Council of Charleston* [(1829), 27 U.S. (2 Pet.) 449, 7 L.Ed. 481], that obligations of the Federal Government are immune from state taxation. This rule, aimed at protecting the borrowing power of the United States from state encroachment, was derived from the 'Borrowing' and 'Supremacy' Clauses of the Constitution, and the constitutional doctrines announced in *McCulloch v. Maryland* [(1819), 17 U.S. (4 Wheat.) 316, L.Ed. 579]."

The required immunity has been recognized in the decisions of this court. See *Federal Life Insurance Co. v. Department of Local Government Affairs* (1976), 65 Ill. 2d

320, 324; *Price Flavoring Extract Co. v. Lindheimer* (1938), 368 Ill. 450, 452; see also Ill. Rev. Stat. 1979, ch. 120, par. 500.4 (exempting from taxation "[p]roperty of the United States, except such property as the United States has permitted or may permit to be taxed").

In *Smith v. Davis* (1944), 323 U.S. 111, 89 L.Ed. 107, 65 S.Ct. 157, the court considered whether an open account, or account receivable, owed to a contractor by the Federal government could be included in the computation of State and local personal property taxes. In determining whether the open account was constitutionally immune from taxation, the court first considered the nature of the claim and then described the characteristics of instrumentalities generally qualifying for exemption. The court said:

> "Such a unilateral, unliquidated creditor's claim, which by itself does not bind the United States and which in no way increases or affects the public debt, cannot be said to be a credit instrumentality of the United States for purposes of tax immunity.
>
> In these respects a mere open account claim differs vitally from the type of credit instrumentalities which this Court in the past has recognized as constitutionally exempt from state and local taxation. Such instrumentalities in each instance have been characterized by (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay." 323 U.S. 111, 114-15, 89 L.Ed. 107, 110-11, 65 S. Ct. 157, 159.

In *Smith* the court also considered, as an inquiry separate from the constitutional question, whether the open account was exempt from taxation under section 3701; at that time the section provided only that "all stocks, bonds,

Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority." In rejecting the taxpayer's argument that the claim was statutorily exempt, the court in *Smith* said:

> "Section 3701 on its face applies only to written interest-bearing obligations issued pursuant to Congressional authorization. Stocks, bonds and Treasury notes are obviously of that nature. And, under the rule of *ejusdem generis*, it is reasonable to construe the general words 'other obligations,' which allegedly cover open accounts, as referring only to obligations or securities of the same type as those specifically enumerated. [Citations.] This interpretation is in accord with the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit. It is unnecessary to extend such tax exemption, at least through statutory interpretation, to non-interest-bearing claims or obligations which the United States does not use or need for credit purposes. Tax exemptions being the exception rather than the rule, much clearer language evidencing an intent to immunize open account claims under section 3701 is necessary under these circumstances." 323 U.S. 111, 116-17, 89 L. Ed. 107, 111-12, 65 S. Ct. 157, 160.

Although *Smith* considered the constitutional and statutory inquiries separately, the statute, as we have said, has been construed by the court as a restatement of the constitutional rule. Therefore, we believe that the separate standards described by the courts are, for our purposes here, overlapping and equally valid. Under the four-part constitutional test set out in *Smith*, the appellate court here concluded that the securities in question were not exempt from State or local taxation. The appellate court believed that the securities did not satisfy the third criterion, a promise to pay specified sums at specified times. The Federal government's undertaking with respect to these various obligations is a guarantee of the payment of principal and interest. The obligation imposed by that is not certain; it may or may not arise, depending on whether a default occurs. Moreover, the securities in question here do not appear to be related to the government's credit needs. The government is not itself the borrower, and it has made the guarantees to induce others to invest in the securities. We do not believe that the securities represent "other obligations of the United States" within the meaning of Section 3701.

Moreover, Congress has the authority to provide for the exemption of these obligations but has not done so. Rather, it has provided only for the exemption of the association itself:

> "The Association [*i.e., GNMA*], including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income, shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority, except that any real property of the Association shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed." 12 U.S.C. sec. 1723a(c)(1) (1976).

In contending for immunity of the types of obligations at issue here, Rockford Life would find support in the decision of the Supreme Court in *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 74 L. Ed. 562, 103 S. Ct. 692. In that case the court held that a tax imposed by the State of Tennessee on banks was discriminatory within the meaning of section 3701; in the computation

of the tax base the taxing statute included income earned from Federal obligations but excluded income earned from obligations of that State or its political subdivisions. (459 U.S. 392, 398-99, 74 L. Ed. 2d 562, 568, 103 S. Ct. 692, 696.) Reaching that conclusion, the court said that it did not need to consider whether the tax was in fact "a 'franchise or other nonproperty ta[x] in lieu thereof.' " 459 U.S. 392, 396 n.6, 74 L. Ed. 2d 562, 567 n.6, 103 S. Ct. 692, 695 n.6.

Rockford Life interprets the Supreme Court's decision in *Memphis Bank* as holding that the particular obligations involved in that case were in fact immune from State and local taxation. The company believes that the obligations at issue here are sufficiently similar to those in *Memphis Bank* that they too must be deemed exempt.

In *Memphis Bank* "[t]he parties stipulated that the amount of tax paid by appellant for the years 1977 and 1978 was based entirely on interest earned on various federal obligations, primarily notes and bills of the United States Treasury and obligations of Federal Credit Banks." (459 U.S. 392, 394-95, 74 L. Ed. 2d 562, 566, 103 S. Ct. 692, 694.) Elaborating on that information, the court explained in a footnote that the tax there "was also based in part on income from obligations of the Farmers Home Administration and the Federal National Mortgage Association." (459 U.S. 392, 395 n.4, 74 L. Ed. 2d 562, 566 n.4, 103 S. Ct. 692, 694 n.4.) The court recognized that Congress had expressed exempted obligations of the Farm Credit Banks from State and local taxation (see 12 U.S.C. secs. 2055, 2079, 2134 (1976)), observing that, "for purposes of federal tax immunity, our cases have made no distinction between the obligations of the United States Treasury and the obligations of the Federal Credit Banks. [Citations.]" 459 U.S. 392, 396 n.5, 74 L. Ed. 2d 562, 567 n.5, 103 S. Ct. 692, 695 n.5.

Rockford Life believes that its securities were materially similar to the Farm Credit Bank, Farmers Home Ad-

ministration, and Federal National Mortgage Association obligations held by the taxpayer in *Memphis Bank*, and the company would conclude that its securities were similarly exempt. We disagree with Rockford Life's broad interpretation of *Memphis Bank*, and we do not believe that that case is controlling here. Although it is true that the exception stated in the second sentence of section 3701, allowing "nondiscriminatory franchise or other nonproperty taxes in lieu thereof," would not need to come into play unless it were first resolved that the obligations in question were in fact "stocks, bonds, Treasury notes and other obligations of the United States," in *Memphis Bank* the initial inquiry into the nature of the obligations was satisfied by the parties' stipulation that the tax did indeed fall entirely on income from exempt obligations. The only remaining questions, then, were whether the tax was being imposed in a discriminatory manner and whether it was a "franchise or other nonproperty ta[x] in lieu thereof." As we have said, the court decided that the tax was being imposed discriminatorily, and therefore the type of the tax did not need to be determined. In *Memphis Bank* it was the parties' stipulation that made section 3701 applicable in the first instance, and we do not construe the case as holding that any particular type of security was tax exempt. As the court indicated, the bulk of the income there came from Treasury notes and bills and from Farm Credit obligations. Because we have determined that *Memphis Bank* does not control here, we need not address Rockford Life's additional argument comparing its obligations to those held by the taxpayer in *Memphis Bank*.

As further support for its argument that the obligations at issue here are exempt from State and local taxation, Rockford Life points to certain official statements made regarding the natures of the Federal guarantees. For example, with respect to the GNMAs, the company cites an Attorney General opinion of May 15, 1970, by

then Assistant Attorney General William H. Rehnquist, who wrote, "I conclude that the Association [*i.e.*, GNMA] is authorized to make the proposed guaranties and that those guaranties would constitute general obligations of the United States backed by its full faith and credit." Rockford Life cites similar evidence regarding the other obligations involved here. We do not interpret these statements as touching on the issue presented. Rather, the concerns expressed were centered on the question whether the particular obligations posed any credit risk. With a government guarantee of the payment of principal and interest, the credit risk of the securities was reduced considerably, which enhanced their attractiveness to the investment community.

For these reasons, then, we conclude that the securities in question here were not "other obligations of the United States" within the meaning of section 3701 and therefore were not exempt from State or local taxation. The Department correctly included them in its assessment of the company's capital stock.

II.

Rockford Life makes the alternative argument that the Department is equitably estopped from including within the computation of the company's capital stock the obligations in question here. Rockford Life points to the Department's exemption of the same or similar securities in previous years, and the company argues that in building a portfolio of investments it justifiably relied on that past practice and accordingly invested in obligations that it believed would be deemed immune from State and local taxation. The appellate court rejected the estoppel argument, concluding that the company's reliance on the previous practice was not reasonable and that no fraud or injustice had occurred.

At the administrative hearing Rockford Life presented its capital stock returns for the four previous years. During that period the company held obligations identical or materially similar to the ones at issue here, and in each of those years the Department either made no assessment or, after final review, cancelled the assessment. Rockford Life contends that in structuring its investment portfolio it relied on the earlier determinations of tax immunity, and the company's intangible property tax returns for the four years preceding 1978 show that as the company's capital stock increased, it invested increasing amounts in these obligations.

The usual elements of estoppel—a party's reasonable and detrimental reliance on the words or conduct of another (*Dill v. Widman* (1952), 413 Ill. 448, 455-56)—must be supplemented here with the additional restriction that a public body will be estopped only when that is necessary to prevent fraud or injustice (*Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill. 2d 427, 448-49), and that is especially true when public revenues are involved (*People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.* (1973), 56 Ill. 2d 210, 220; *Austin Liquor Mart, Inc. v. Department of Revenue* (1972), 51 Ill. 2d 1, 4-5). This court previously had held that the State is not estopped from reexamining a taxpayer's liability even though the return for that period has been approved (*People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.* (1973), 56 Ill. 2d 210; *Austin Liquor Mart, Inc. v. Department of Revenue* (1972), 51 Ill. 2d 1), and the Department's change in policy here would not necessarily be more burdensome or unjust than a reexamination of taxpayer's returns. We do not believe that the circumstances here show that the company has suffered fraud or injustice.

Moreover, it is not clear that Rockford Life actually suffered any harm from the Department's change in policy. The detriment to Rockford Life in this case would be measured not simply by the amount of the company's ultimate tax liability but would depend also on the relative returns provided by the various investment alternatives.

This became clear at the administrative hearing, during the testimony of the company's investment manager. In explaining the company's reliance on the Department's previous practice, Mr. Ray testified:

> "Now, had we known that there was going to be a change in the attitude toward GNMA's from prior years when there was—
>
> Q: When they were not taxed?
>
> A: When they were not taxed, then probably we would have had to buy U.S. Treasury, direct U.S. Treasury obligations.
>
> Q: Or some other investment?
>
> A: Or some other investment. But in so doing, if we had bought U.S. Treasury obligations, that would have brought less income to the company because the income from the U.S. Treasury is less than on a GNMA."

Thus, it is not clear that the company actually suffered any harm from investing in the higher yielding, taxable obligations rather than in the lower yielding, tax-immune Treasury obligations.

Therefore, we conclude that the obligations in question here were not exempt from State or local taxation, and that the Department was not estopped from including them here in Rockford Life's capital stock. For the reasons stated, the judgment of the appellate court is affirmed.

Judgment affirmed

ORDER DENYING PETITION FOR REHEARING

61116

ILLINOIS SUPREME COURT
JULEANN HORNYAK, CLERK
Supreme Court Building
Springfield, Ill. 82706
(217) 782-2035

June 2, 1986

Mr. John C. McCarthy
Williams & McCarthy
P.O. Box 219
Rockford, IL 61105

No. 61116—Rockford Life Insurance Company, etc., appellant, v. Department of Revenue of the State of Illinois, et al., etc., appellees. Appeal, Appellate Court, Second District.

The Supreme Court today *DENIED* the petition for rehearing in the above entitled cause.

The mandate of this Court will issue to the appropriate Appellate Court and/or Circuit Court or other agency on June 12, 1986.

ILLINOIS APPELLATE COURT OPINION

IN THE APPELLATE COURT OF ILLINOIS
SECOND DISTRICT

Nos. 83-826, 83-627

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Plaintiff-Appellant,

v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS and JAMES B. ZAGEL,
Its Director,
Defendants-Appellees.

Appeal from the Circuit Court of the
17th Judicial Circuit,
Winnebago County, Illinois

PEOPLE OF THE STATE OF ILLINOIS
ex rel. DOUGLAS R. AURAND,
TREASURER and EX-OFFICIO COUNTY
COLLECTOR OF WINNEBAGO COUNTY, ILLINOIS,
Plaintiff-Appellee,

v.

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Defendant-Appellant.

Appeal from the Circuit Court of the
17th Judicial Circuit,
Winnebago County, Illinois

[Filed Oct. 26, 1984]

JUSTICE LINDBERG delivered the opinion of the court.

Plaintiff, Rockford Life Insurance Company (Rockford) appeals from an order of the circuit court of Winnebago County affirming the 1978 assessment of its capital stock by defendant-appellee, Department of Revenue (Department). Rockford also appeals from the order in the case consolidated with the instant appeal entering judgment against Rockford in the amount of $723,053.70 and costs. Rockford argues that certain of its securities (mortgage-backed securities of the Government National Mortgage Association (GNMA), and obligations issued pursuant to the New Communities Act (NCA), the New Community Development Act (NCDA), and the Merchant Marine Act (MMA) improperly were included in the capital stock assessment because they are direct obligations of the United States immune from state taxation. Because we conclude the obligations at issue are not direct obligations issued by the Federal government, we affirm.

On December 21, 1978, the Illinois Department of Local Government Affairs assessed the capital stock of Rockford for the year 1978 at a value of $6,937,000. Review of the assessment was requested by Rockford, and on May 2, 1979, the Illinois Department of Local Government Affairs, by letter, confirmed the assessment. Rockford thereupon filed a complaint in the circuit court of Winnebago County, Illinois, pursuant to the Administrative Review Law (Ill. Rev. Stat. 1979, ch. 110, par. 264 *et seq.*). Following hearings on motions, the court ordered that the case be remanded to the Department of Local Government Affairs with instructions to formally notify Rockford of its decision in accordance with its rules. On October 29, 1979, the Department of Local Government Affairs served notice of its decision confirming the assessment. Pursuant to Rockford's request, the

Department of Revenue (as successor to the Department of Local Government Affairs) held a hearing on December 21, 1979. Following the hearing, the director of the Department affirmed the assessment.

The company thereafter filed its complaint seeking judicial review of the decision of the Department affirming the 1978 assessment and the Department filed the administrative record as its answer to the complaint. In the trial court, Rockford argued that: (1) since the three types of securities were exempt as U.S. obligations under the Constitution and statutes of the United States, their value could not be included in computing the capital stock assessment; and (2) the Department was estopped because of its exclusion of the securities in 1974 through 1978 from including these securities in the 1978 capital stock assessment. In a memorandum decision, the trial court affirmed the Department's ruling and entered the following findings: (1) the securities in question were not "obligations of the United States" under 31 U.S.C. § 742 (1976) and therefore were not constitutionally immune from state taxation; (2) the Department's erroneous inclusion of non-exempt property as exempt property in its property tax manual did not preclude subsequent correction of the error and taxation of the property; and (3) the necessary fraud or injustice required for the application of the doctrine of estoppel was not demonstrated by the erroneous ruling of the Department or its failure to assess taxable property in prior years. Rockford filed a timely appeal from the trial court order entered on June 10, 1983, affirming the Department assessment. This appeal solely concerns the capital stock assessment against Rockford for 1978 because the capital stock tax was abolished on January 1, 1979 by Article IX, section 5 of the Constitution of Illinois of 1970. Ill. Const. 1970, art. IX, section 5.

Rockford asserts that the Department is estopped from assessing the securities in question because of its previous administrative determinations that the securities were

exempt from state taxation. The doctrine of equitable estoppel is "the effect of the voluntary conduct of a party whereby he is precluded from asserting his rights which might otherwise have existed as against another party who has relied in good faith upon such conduct and has been led thereby to change his position for the worse." (*Tyska v. Board of Education* (1983), 117 Ill. App. 3d 917, 930, 453 (N.E.2d 1344, 1355; *Kyker v. Kyker* (1983), 117 Ill. App. 3d 547, 453 N.E.2d 108.) The party claiming the estoppel must have relied upon the acts or representations of the other and have had no knowledge or convenient means of knowing the true facts. *Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill.2d 427, 447, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957.

The doctrine of estoppel can be applied against the State when acting in a governmental capacity only in the most compelling circumstances. (*Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill.2d 427, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957; *Tyska v. Board of Education* (1983), 117 Ill. App. 3d 917, 453 N.E.2d 1344; *see generally* Annot., 21 A.L.R.4th 573 (1983).) "[W]here public revenues are involved, public policy ordinarily forbids the application of estoppel to the State" and "'[t]he government is not estopped by previous acts or conduct of its agents with reference to the determination of tax liabilities or by failure to collect the tax, nor will the mistakes or misinformation of its officers estop it from collecting the tax'." (Citations omitted.) *Austin Liquor Mart, Inc. v. Dept. of Revenue* (1972), 51 Ill. 2d 1, 4-5.

While acknowledging the principle that a State will generally not be estopped from collecting a tax, Rockford argues this case presents extraordinary circumstances justifying application of the estoppel doctrine and relies upon *Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill.2d 427, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806,

87 S.Ct. 957, for support. In *Hickey*, a railroad maintained and improved large amounts of lakefront property for over 50 years. Refusing to recognize "a right in the State officially disclaimed [by the State] for half a century" (35 Ill.2d 427, 449), the supreme court held the State should be estopped from now asserting its interest in the subject property. The court in *Hickey* emphasized the railroad's reliance on the State's position:

> "Meanwhile, numerous other lake shore boundary line agreements have been consummated and confirmed, conveyances made, leases executed and options granted; proposals for lake shore development were agreed upon and accepted whereby substantial construction obligations were apportioned as between the city, Park Commissioners and the railroad in reliance upon the assumption that the railroad was the fee owner of the lands it occupied * * *." (35 Ill.2d 427, 450.)

Therefore, while the *Hickey* court reiterated that qualified immunity from the estoppel doctrine was enjoyed by the State, it held that under these "extraordinary circumstances", the State was estopped from asserting its latent title claim.

Rockford argues the circumstances here similarly are "extraordinary. In the case at bar Rockford reported NCA obligations on its 1974 tax return which were initially assessed but were later ruled exempt by the Director. In 1975, Rockford reported NCA and GNMA obligations which were initially assessed, but were later deducted from its capital stock assessment. Rockford in its 1976 return reported MMA obligations in addition to the GNMA obligations which the Director initially assessed, but upon reconsideration exempted from the capital stock tax computation. In its 1977 return, Rockford reported additional GNMA and MMA obligations as deductions which the Department allowed. In 1978, the Department

reversed its prior position and decided that the GNMA, MMA, NCA and NCDA obligations were subject to the capital stock tax.

Rockford argues that these circumstances constitute appropriate grounds for estoppel and contends all of the elements of the doctrine are satisfied: (1) positive acts by the Departments; (2) justifiable reliance by Rockford upon these acts; (3) amounting to fraud and injustice. Rockford cites the regulations contained in the Department's manual and the approval of the exemption in the years 1974-77 as positive acts by the State. The Department counters that its exemptions of these securities at issue are less affirmative than were the actions of the State in *Austin Liquor Mart, Inc. v. Department of Revenue* (1972), 51 Ill.2d 1, where the Department accepted payment from the taxpayer of his assessment and then attempted to reopen the investigation concerning the period covered by the assessment. The Department also quotes supreme court language that "State inspectors perform[ing] the ministerial acts of computing the tax due under one particular formula does not estop the State from repudiating that formula." (*People ex rel. Scott v. Chicago Thoroughbred Enterprises, Inc.* (1973), 56 Ill. 2d 210, 220.) Nevertheless, we conclude the approval of the exemption constitutes a positive act of the State.

Rockford also asserts it relied upon the exemption, planning its investment strategy on the assumption that the obligations would continue to be excluded from calculation of the capital stock tax. Rockford's additional purchases of the subject obligations in the years 1974 through 1977 arguably provide some evidence of reliance by Rockford on the acts of the Department. However, Rockford's reliance was not reasonable. The taxable nature of these securities was unclear during at least three of the four subject years. No court decision or legislative pronouncement had resolved the issue, and therefore, Rockford's reliance on the inconsistent Depart-

ment ruling was unjustified. This is especially true because unlike the 50-year time period in *Hickey*, here the Department had only exempted the obligations for four years prior to its decision to include them in the tax calculation. The Department also raises a persuasive public policy argument, stating that were this court to apply the estoppel doctrine on the basis of four years of inconsistent Department actions, an administrative agency considering a novel issue would be bound by its initial ruling and would be precluded from adopting a new policy or from correcting an erroneous construction of the applicable law.

While the absence of reasonable reliance is alone fatal to Rockford's estoppel claim, Rockford has also failed to establish fraud. Rockford's allegations of fraud are unpersuasive. Rockford cites the fact that the Department's policy change resulted in almost a $500,000 tax liability, but the magnitude of the tax does not establish the existence or absence of fraud. Additionally, Rockford states that the Department's delay in assessing the tax until the last year of the capital stock tax "raises the inference of a calculated plan to catch this taxpayer off-guard." This allegation, however, is unsupported. Any allegation that the Department was negligent also does not amount to fraud.

> "More importantly, perhaps, is the possibility that application of *laches* or estoppel doctrines may impair the functioning of the State in the discharge of its government functions, and that valuable public interests may be jeopardized or lost by the negligence, mistakes or inattention of public officials." (*Hickey v. Illinois Central R.R. Co.* (1966), 35 Ill. 2d 427, 444-48, *cert. denied* (1967), 386 U.S. 934, 17 L.Ed.2d 806, 87 S.Ct. 957.)

In the absence of any proof that the Department's action constituted a fraud resulting in an injustice done to Rockford, the State should not be estopped from includ-

ing the subject obligations in Rockford's capital stock tax calculation for 1978.

Rockford next contends that the debt obligations here were improperly included in the capital assessment because they constitute property of the United States immune from state taxation.

A. GNMA OBLIGATIONS

GNMA is a government-sponsored private corporation which was created in 1968 out of and partitioned from the Federal National Mortgage Association (FNMA). Both FNMA and GNMA are authorized to "purchase, service, sell, or otherwise deal in any mortgages which are issued after [a variety of federal statutes]." (12 U.S.C. § 1717(b)(1) (1976).) GNMA's role is to implement the mortgage-backed securities program. GNMA enters into "Guaranty Agreements" with private investors who assemble pools of mortgages and issue them for public offering. The issuer retains title to the pool, but assigns its rights in the underlying mortgages to GNMA. *New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411, n.2.

The assignment remains unrecorded "unless the issuer defaults on payments to security holders and GNMA exercises its option to assume issuer responsibilities." (*New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 422, 428.) GNMA's guarantee of the issuer's mortgage pools, however, "will not bring about an increase in the government's total contingent liability * * * GNMA is authorized to collect a fee for its guarantee, and it is intended that this program will be fully self-supporting and will operate at no cost to the Government." 114 Cong. Rec. 15, 236 (1968) (remarks of Sen. Bennett).

The full faith and credit of the United States is pledged to the payment of all amounts which may be required to

be paid under the guarantee. (12 U.S.C. § 1721(g) (1976).) The purpose of FNMA and GNMA is "to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing * * *." 12 U.S.C. § 1716(a) (1976).

B. NCA AND NCDA OBLIGATIONS

The New Communities Act of 1968 (42 U.S.C. § 3901 (1976) *et seq.*) and the Urban Growth and New Community Development Act of 1970 (42 U.S.C. § 4501 (1976) *et seq.*) attempt to "facilitat[e] the entitlement of private capital in new community development" (42 U.S.C. § 3901 (1976)), and to provide for the development of a national urban growth policy and to encourage the "rational, orderly, efficient, and economic growth, development, and redevelopment of our States, metropolitan areas, cities, counties, towns, and communities * * *." (42 U.S.C. § 4501 (1976).) These Acts authorize the Secretary of Housing and Urban Development (HUD), in the case of the former Act, and the Secretary acting through the community development corporation, in the case of the latter enactment, to guarantee bonds, debentures, notes or other obligations of eligible new community developers as the means of carrying out their governmental purposes. (*See* 42 U.S.C. § 3902 (1976) and 42 U.S.C. § 4514 (1976).) The full faith and credit of the United States is pledged to the guarantee of the payment of such obligations. (42 U.S.C. § 3906(b) (1976) and 42 U.S.C. § 4514(b) (1976).) In return for the guarantee, the issuer pays to the Secretary a fee. 42 U.S.C. § 3905 (1976).

C. MMA OBLIGATIONS

The Merchant Marine Act of 1936 establishes a Federal Ship Financing Fund "to foster the development and encourage the maintenance of such a merchant marine." (46 U.S.C. § 1101 (1976).) To that purpose, the Secretary of Commerce may authorize guarantees of principal and interest on bonds issued by private obligors. (46 U.S.C. § 1273(a) (1976).) The Secretary receives from the obligor a security interest, perfected only upon default. (46 U.S.C. § 1273(b) (1976).) The program, furthermore, is self-supporting. The obligor pays a fee to the Secretary. (46 U.S.C. § 1274(e) (1976).) The full faith and credit of the United States is pledged to the payment of these guarantees under 46 U.S.C. § 1273(d) (1976).

These debt securities all have certain characteristics in common: they are issued by private parties, guaranteed by the full faith and credit of the United States government, and the United States government receives the fee for the grantees. Since of these securities GNMA obligations have the most indicia of tax-exempt status and since the parties almost exclusively discuss GNMA obligations, the following analysis will refer solely to GNMA obligations even though the conclusions reached are equally applicable to MMA, NCA and NCDA obligations.

In support of its contention that the obligations here are tax exempt, Rockford advances constitutional and statutory arguments. The constitutional argument is based upon the doctrine of implied powers recognized in *M'Culloch v. State of Maryland* (1819), 17 U.S. (4 Wheat.) 316, 4 L.Ed. 579. Under the rule first announced in *M'Culloch*, all properties, functions and instrumentalities of the Federal government are immune from state and local taxation. (*Montgomery Ward Life Insurance Co. v. State Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 411 N.E.2d 973, citing *Smith v. Davis* (1944), 323 U.S. 111, 113, 89 L.Ed. 107, 110, 65 S.Ct. 157, 158-59.) In *M'Culloch*, the Supreme Court struck down on the authority of the Supremacy Clause a state tax on the national bank which the government had established.

"The result is a conviction that the states have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the general government. This is, we think, the unavoidable consequence of that supremacy which the Constitution has declared." (17 U.S. (4 Wheat.) 316, 436, 4 L.Ed. 579, 609.)

The *M'Culloch* court, however, restricted the breadth of its holding:

"This opinion does not deprive the states of any resource which they originally possessed. It does not extend to a tax paid by the real property of the bank, in common with other real property within the state, nor to a tax imposed on the interest which the citizens of Maryland may hold in this institution, in common with other property of the same description throughout the state." 17 U.S. (4 Wheat.) 316, 436, 4 L.Ed. 579, 609.

Congress had codified this constitutional immunity by exempting from state and local taxation certain written obligations. (*See* 31 U.S.C. § 742 (1976), now codified as 31 U.S.C.A. § 3124(a) (West Supp. 1983); *see Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 411 N.E.2d 973.) That section provided:

"Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes

in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." (31 U.S.C. § 742 (1976).)

The Supreme Court recently stated that its previous decisions have treated section 742 principally as a restatement of the constitutional rule regarding the immunity of federal government property including bonds and other securities from taxation by the states. (*Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. ——, ——, 74 L.Ed.2d 562, 567, 103 S.Ct. 692, 696.) The basis of the statutory exemption is "the fact that a tax upon the obligations of the United States is virtually a tax upon the credit of the government, and upon its power to raise money for the purpose of carrying on its civil and military operations." (*Hibernia Savings & Loan Society v. San Francisco* (1906), 200 U.S. 310, 313, 50 L.Ed. 495, 496, 26 S.Ct. 265, 266.) Since the question whether the subject obligations are constitutionally immune from taxation or are exempt by 31 U.S.C. § 742 (1976), is answered by examining the nature of the government's undertaking in the certificates themselves (*Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 297, 411 N.E. 2d 973, 977; *see also Farmers & Traders State Bank v. Johnson* (1984), 121 Ill. App. 3d 43, 45, 458 N.E.2d 1365, 1367), and since section 742 is primarily a restatement of the constitutional role, both the constitutional and statutory inquiries will be considered together.

The question thus presented, Rockford asserts, is whether the four debt obligations at issue here are constitutionally immune from the Illinois Capital Stock Tax or are "other obligations of the United States" exempt from state taxation under 31 U.S.C. § 742 (1976). The Supreme Court in *Smith v. Davis* (1944), 323 U.S. 111, 114-15, 89 L.Ed. 107, 110-11, 65 S.Ct. 157, 159, enumerated certain attributes of exemption obligations:

"(1) writen documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sum as specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay."

The court in *Montgomery Ward* applied the *Smith* criteria to GNMA obligations and determined that GNMA certificates "satisfy all of the above requirements except for 'a binding promise by the United States to pay specified sums at specified dates'." (89 Ill. App. 3d 292, 297, 411 N.E.2d 973, 976.) While recognizing that the certificates represent some sort of obligation of the United States, the *Montgomery Ward* court employed the *ejusdem generis* rule (rule of construction whereby general terms will be construed to include only things of same general class as those enumerated, Black's Law Dictionary 464 (5th ed. 1979)), and concluded that the term "other obligations" in section 742 did not include GNMA obligations in part because they are privately issued.

Rockford challenges the *Montgomery Ward* court's statement that "Ginnie Maes are issued by a private issuer and not the government * * *." (89 Ill. App. 3d 292, 298, 411 N.E.2d 973, 977.) Review of the GNMA mortgage-backed securities program described by the court in *New York Guardian Mortgage Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411, however, makes clear that the issuer is a private entity.

"A financial institution or mortgage servicing company wishing to participate must assemble or acquire a pool of government insured or guaranteed mortgages. GNMA then enters into a standard form 'Guaranty Agreement' with the issuer (this Guaranty Agreement is set forth at Appendix 19 to the GNMA Mortgage Backed Securities Guide, GNMA 5500.1 Rev. 4 (hereafter referred to as 'GNMA

Guide')), under which, *inter alia*, GNMA agrees to guarantee timely payments of principal and interest as required by the terms of the securities (Guaranty Agreement § 6.01, and the issuer agrees to remit in a timely manner all payments required by the terms of the securities. Guaranty Agreement § 4.01. Should the issuer fail to make timely payments as required, the security holder's sole recourse is against GNMA (*Id.* § 7.01). However, GNMA may treat the issuer's failure to make required payments as an event of default under the Guaranty Agreement (§ 8.01), and this provides GNMA with the option of existingishing the issuer's interest in the pooled mortgages and becoming owner of those mortgages 'subject only to the unsatisfied rights of the holders of the securities. . . .' 12 U.S.C. § 1721(g) (1976); Guaranty Agreement § 8.05." (Footnote omitted.)

Additionally, the issuer is named specifically on the GNMA certificate contained in the trial record as the issuer of the security. We therefore are unpersuaded by Rockford's contention that the *Montgomery Ward* court erred in concluding that GNMA certificates are issued by a private issuer.

Rockford also contests the *Montgomery Ward* court's statement that the "priavte issuer is primarily liable to make the monthly interest payment and ultimately repay the principal." (89 Ill. App. 3d 292, 298, 411 N.E.2d 973, 977.) Noting that the payments do not become an obligation of GNMA unless and until the issuer defaults, the *Montgomery Ward* court characterized that eventuality as "contingent and wholly speculative." (*Montgomery Ward.*) Rockford responds that in reality, the government and not the private issuer is primarily responsible because each certificate is signed only by GNMA and because both the GNMA guide and security certificate say GNMA and not the issuer is liable for the guarantee.

This statement concerning the guide and certificate is accurate because GNMA and not the issuer *guarantees* the obligation. This fact, however, does not make GNMA primarily liable as argued by Rockford. Rather, the issuer assumes primary responsibility for payments to the security holders. Also, as the Department points out, *New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411, cited by Rockford recognized that the assignment to GNMA of the issuer's rights and liabilities only occurs upon the issuer's default.

Rockford's depiction of the issuer as simply an agent of GNMA responsible merely for collecting and distributing funds is belied by the *Cleland* court's description of the issuer's duties concerning section 1721(g) modified pass-through mortgages which are the subject of this action.

> "Federal regulations establish two types of mortgage backed securities: 'straight pass-through' securities, which provide for the payment by the issuer to the security holders of 'principal and interest [generated by the underlying pool of mortgages] *as collected*' and 'modified pass-through' securities, which 'provide for such payment, *whether or not collected*, of both specified principal installments and a fixed rate of interest on the unpaid principal balance, with all prepayments being passed through to the holder.' 24 CFR § 390.5 (1978) (emphasis added)." (*New York Guardian Mortgagee Corp. v. Cleland* (S.D.N.Y. 1979), 473 F. Supp. 409, 411.)

Because the certificates here are modified pass-through securities, the issuer was responsible to make principal and interest payments to Rockford even if it had not yet received payments from the mortgagors. The existence of this obligation supports the *Montgomery Ward* court's conclusion that the issuer and not GNMA is primarily liable for the principal and interest due on the certificates.

Rockford also challenges a finding of the *Montgomery Ward* court that the GNMA obligations "were not issued by a government agency to borrow money on the credit of the United States to finance an essential government function." (*Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs* (1980), 89 Ill. App. 3d 292, 297, 411 N.E.2d 973, 977.) Rockford maintains on the authority of two Supreme Court decisions that the *Montgomery Ward* court erred in distinguishing GNMA obligations on this basis. In *People ex rel. The Bank of New York National Banking Association v. Hoffman* (1869), 74 U.S. (7 Wall.) 16, 19 L.Ed. 57, the court concluded that certificates of indebtedness issued by the Federal government to creditors in exchange for supplies were exempt from state taxation. The *Hoffman* court stated:

> "But we fail to perceive * * * that such certificates [certificates of indebtedness issued by the Federal government in exchange for goods or services], *issued* as a means of executing constitutional powers of the government other than of borrowing money are not as much beyond control and limitation by the States through taxation, as bonds or other obligations issued for loans of money." (Emphasis added.) (74 U.S. (7 Wall.) 16, 24, 19 L.Ed. 57, 60.)

Rockford emphasizes the language that the certificates were issued as a means of executing constitutional powers other than of borrowing money in an effort to discredit the *Montgomery Ward* court's finding that GNMA obligations were not issued by the government to borrow money. However, as the Treasurer points out, the court in *Hoffman* was discussing two types of debt instruments issued directly by the Federal government. The GNMA obligations here were not issued by the Federal government, but rather by private entities.

In the second case cited by Rockford, *Hibernia Savings & Loan Society v. San Francisco* (1906), 200 U.S. 310, 50 L.Ed. 495, 26 S.Ct. 265, the Supreme Court rejected the claim that checks issued in payment of interest accrued upon registered bonds of the United States were entitled to exemption from state taxation. Rockford relies upon *Hibernia* because that Court stated that the test for determining exemptions was whether the tax hindered the effective exercise of the government agent's function. The Department counters that the test articulated in *Hibernia* only applies to cases where the United States' obligations are at issue; otherwise, tax exemption would apply to any area in which the Federal government in some manner had acted. We are persuaded by the Department's argument that the scope of the *Hibernia* language is too broad to be useful as a test in the case at bar. Furthermore, even if the test were applicable, the effect of the capital stock tax does not "deprive * * * [the private corporations] of power to serve the government as they were intended to serve it * * *" (*Hibernia Savings & Loan Society v. San Francisco* (1906), 200 U.S. 310, 315, 50 L.Ed. 495, 497, 26 S.Ct. 265, 267), for Rockford has cited no evidence in the record that issuers have been unable to market these certificates because they are taxable by the States. Therefore, the government function test does not aid Rockford.

The next argument raised by Rockford is that the *Montgomery Ward* court erred in limiting the exempt status to direct obligations issued by the United States in which it alone makes a binding promise to pay. Instead, Rockford contends that section 742 should be construed broadly, and relies upon *Smith v. Davis* (1944), 323 U.S. 111, 89 L.Ed. 107, 65 S.Ct. 157, for support. In *Smith*, the Court held that the debt owed by the United States could be taxed by State officials because the debt did not constitute a credit instrumentality within

the meaning of the constitutional immunity from state taxation. Rockford recognizes the four incidents of credit instrumentalities previously discussed, but then cites the following language of the *Smith* court as the appropriate rule to apply to the instant facts:

> "All of these related statutes are a clear indication of an intent to immunize from state taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry on the necessary functions of government." (*Smith v. Davis* (1944), 323 U.S. 111, 119, 89 L.Ed. 107, 113, 65 S.Ct. 157, 161.)

Rockford argues that GNMA obligations serve the necessary government function of insuring adequate funding for home mortgages and that the tax exempt nature of the mortgage-backed securities is necessary to attract adequate capital. Rockford does not explain, however, why this test should be employed to the exclusion of the four criteria also enunciated by the *Smith* court. Furthermore, the above language requires that the certificate be an obligation of the United States. In contrast to the position advanced by Rockford, we conclude as did the court in *Montgomery Ward* that the obligations involved here are not direct obligations of the United States.

In further challenging the *Montgomery Ward* court's limitation of state tax exemption to direct and exclusive obligations of the Federal government, Rockford argues that to fall within the constitutional exemption, the obligation need not be directly issued by the United States government as long as the obligation is issued by an instrumentality of the government to carry out its governmental function or is guaranteed by the full faith and credit of the United States. Rockford places great emphasis on the Supreme Court's recent decision in *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. ——, 74 L.Ed.2d 562, 103 S.Ct. 692. There, a Tennessee statute authorized a tax on a bank's net earnings income

from Federal obligations and defined net earnings to include interest earned from obligations of the United States and its instrumentalities, but excluded interest on similar obligations of Tennessee and its political subdivisions. The Supreme Court held that the state bank tax violated the immunity enjoyed by United States obligations from state and local taxation. The *Memphis Bank* court noted that the disputed tax was based upon interest earned "on various federal obligations, primarily notes and bills of the U.S. Treasury and obligations of the Federal Credit Banks" (459 U.S. ——, ——, 74 L.Ed. 2d 562, 566, 103 S.Ct. 692, 695), and also noted in a footnote that FNMA obligations were held by the bank. (49 U.S. ——, —— n.4, 74 L.Ed.2d 562, 566 n.4, 103 S.Ct. 6992, 695 n.4.) This reference to FNMA obligations is the only one contained in the entire opinion. Therefore, we are more hesistant than in Rockford to interpret the *Memphis Bank* decision as holding that FNMA certificates are federal obligations exempt from State taxation under section 742.

Even if *Memphis Bank* holds that FNMA obligations are exempt, however, that decision did not involve GNMA certificates. As the *Montgomery Ward* court recognized, GNMA certificates issued pursuant to section 1721(g) are significantly different than are FNMA certificates.

> "In this regard the Ginnie Maes issued in the instant case under 12 U.S.C. § 1721(g) (1976) differ from Mortgage Participation Certificates issued under 12 U.S.C. § 1717(c) (1976) and the Fannie Maes issued under 12 U.S.C. § 1719(d) (1976). Under the latter two sections FNMA and GNMA issue the certificates and are directly liable for payment. By contrast, the instant guarantee of payment is truly an indirect and contingent obligation of the United States and does not exempt the Ginnie Maes from State taxation." (89 Ill. App. 3d 292, 299, 411 N.E. 2d 973, 978.)

The presence of both a private issuer and the indirect liability of GNMA distinguishes GNMA section 1721(g) certificates from those issued directly by FNMA and thus, *Memphis Bank* is not determinative of the case at bar. *Montgomery Ward* therefore is the only case directly on point and we find its reasoning persuasive.

Rockford also argues that the GNMA obligations are exempt from state taxation because GNMA is a federal instrumentality and cites *Rust v. Johnson* (9th Cir. 1979), 597 F.2d 174, *cert. denied*, 444 U.S. 964, 62 L. Ed.2d 376, 100 S.Ct. 450, which held that a city's foreclosure on property without providing for FNMA's interest in the property was an unconstitutional exercise of state power over property of the Federal Government in violation of the Supremacy Clause. Despite the *private ownership* of FNMA, the *Rust* court held that FNMA was a federal instrumentality and its interest in the property was "property of the United States." *Rust*, however, does not require the conclusion that GNMA securities are United States property. Unlike FNMA securities, GNMA securities are issued and serviced by private issuers. Therefore, even if GNMA is considered a federal instrumentality, the burden of the capital stock tax did not fall directly upon the instrumentality, but rather upon those who purchased the GNMA securities. This indirect burden on GNMA is insufficient to warrant state tax exemption.

> "A state tax is not within the inhibition of state taxation of federal instrumentalities unless it is in fact a tax directly upon the government instrumentality, or its effect is so direct as to constitute it a substantial, as distinguished from an indirect and remote, interference with the exercise of the governmental functions delegated to the federal instrumentalities." (71 Am. Jur. 2d *State and Local Taxation* § 224 (1973).)

As the tax does not fall directly upon any federal instrumentality and as Rockford has not demonstrated how inclusion of the privately-issued GNMA certificates in the capital stock tax calculation constitutes a substantial interference with the exercise of GNMA governmental functions, the certificates are not constitutionally or statutorily immune from state taxation.

Accordingly, we affirm the order of the district court of Winnebago County.

AFFIRMED.

SEIDENFELD, P.J., HOPF, J., concur.

UNITED STATES OF AMERICA

STATE OF ILLINOIS,)
APPELLATE COURT,) ss.
SECOND DISTRICT,)

I, LOREN J. STROTZ, Clerk of the Appellate Court, in and for said Second Judicial District of the State of Illinois, and the keeper of the Records and Seal thereof, do hereby certify that the foregoing is a true, full and complete copy of the decision of the said Appellate Court in the above entitled cause of record in my said office.

In TESTIMONY WHEREOF, I have set my hand and affixed the seal of the said Appellate Court, in Elgin, in said State, this 26th day of October, A.D. 1984.

/s/ Loren J. Strotz
Clerk Appellate Court
Second District

JUDGMENT ORDER—CIRCUIT COURT OF THE SEVENTEENTH JUDICIAL DISTRICT (Case No. 80-TX-21)

STATE OF ILLINOIS
IN THE CIRCUIT COURT
OF THE 17TH JUDICIAL DISTRICT
COUNTY OF WINNEBAGO

No. 80-TX-21

PEOPLE OF THE STATE OF ILLINOIS ex rel. DOUGLAS R. AURAND, COUNTY TREASURER and EX-OFFICIO COUNTY COOLLECTOR OF WINNEBAGO COUNTY, ILLINOIS,
Plaintiff,

vs.

ROCKFORD LIFE INSURANCE COMPANY,
Defendant.

JUDGMENT ORDER

This cause coming on for hearing before the Court upon the Complaint of Plaintiff and upon the Answer of the Defendant Rockford Life Insurance Company, the parties having appeared by their respective attorneys, the Court having heard the arguments of counsel, and being fully advised in the premises;

NOW, THEREFORE, THE COURT FINDS as follows:

1. That it has jurisdiction of all parties to, and the subject matter of, the above entitled cause;

2. That all of the material allegations of the Complaint have been proved and the true, and the plaintiff is entitled to the relief prayed in the complaint;

3. The assessment, for purposes of the Illinois capital stock property tax, of debentures issued under the New Communities Act (42 U.S.C. § 2901 et seq.); the United States Guaranteed Ship Financing Bonds; and the Mortgage Backed Certificates guaranteed by Government National Mortgage Association is not prohibited by the laws of the State of Illinois or the statutes or Constitution or laws of the United States; said obligations not being exempt from such taxation.

4. The Department of Revenue is not estopped to tax said securities after long standing prior determination of their exemption.

5. There is now due and owing by Defendant, Rockford Life Insurance Company, to Plaintiff, the sum of $456,184.06 as personal property taxes for the 1978 assessment year, plus interest and publication costs in the amount of $266,869.64.

WHEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED THAT:

1. Judgment be entered for Plaintiff and against the Defendant in the amount of $723,053.70 plus costs;

2. Execution shall stay pending appeal of this cause and Case No. 80-MR-26 pending in this Court with bond constituting the deposit of the sum equal to the judgment entered herein in an interest bearing escrow account to be established by the Defendant, with an Escrow Agent mutually agreed upon by the parties; interest which is earned on that escrow account shall be retained in the account; upon entry of final judgment on the final appeal in said causes, the Escrow Agent shall distribute the funds as follows:

(a) If Plaintiff shall be the ultimately prevailing party, Plaintiff shall receive the amounts deposited by Defendant in the Escrow Account and any interest earned thereon, up to the amount of statutory interest

that would accrue on the unpaid judgment; any interest earned on the escrow account in excess of the statutory interest on judgments shall be returned to Defendant;

(b) If Defendant shall be the ultimately prevailing party, Defendant shall receive all amounts deposited in the Escrow Account and all interest earned by such account.

Dated: June 10, 1983

ENTER:

/s/ John E. Sype
Judge

APPROVED AS TO FORM:

/s/ James Rees
Attorney for Plaintiff

/s/ John C. McCarthy
Attorney for Defendant

JUDGMENT ORDER—CIRCUIT COURT OF THE SEVENTEENTH JUDICIAL DISTRICT (Case No. 80-MR-26)

STATE OF ILLINOIS
IN THE CIRCUIT COURT
OF THE SEVENTEENTH JUDICIAL CIRCUIT
COUNTY OF WINNEBAGO

No. 80-MR-26

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Plaintiff,

v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS
and JAMES B. ZAGEL, its Director,
Defendants.

JUDGMENT

This cause regularly coming on for hearing before the Court upon the Complaint of Plaintiff, Rockford Life Insurance Company, for review of a decision rendered by Defendant, Department of Revenue of the State of Illinois, in a certain proceeding pending before it entitled In The Matter Of: Rockford Life Insurance Company Docket No. I-18-78, and upon the Answer of said Defendant consisting of the transcript of the record of said proceeding; the parties having appeared by their respective attorneys; and the Court having examined said record, having heard arguments of counsel, and being fully advised in the premises;

NOW, THEREFORE, THE COURT FINDS as follows:

1. That the Government National Mortgage Association Securities, Ship Financing Bonds, and the New Community Debentures, owned by the Plaintiff, Rockford Life Insurance Company, during 1378 were not exempt from State capital stock taxation under either the Federal or Illinois Constitution and/or laws; and

2. That the assessment of those securities by the Illinois Department of Revenue for the 1978 tax year, as stated in its administrative decision, is lawful; and

3. That the Illinois Department of Revenue is not estopped from assessing or taxing said securities as a result of its earlier Rules or policy of exempting them.

WHEREFORE, IT IS HEREBY ORDERED, ADJUDGED AND DECREED that the decision of the Director of the Illinois Department of Revenue affirming the 1978 assessment of the securities owned by the Plaintiff, Rockford Life Insurance Company, at $6,937,000, be and is hereby, wholly affirmed.

Dated this 10th day of June, 1983.

ENTER:

/s/ John E. Sype
Judge
Filed June 10, 1983

/s/ Ronald Kotche
Clerk

APPROVED AS TO FORM:

/s/ John R. Simpson
JOHN R. SIMPSON
For the Illinois Department of Revenue

/s/ James Rees
For The County of Winnebago, Illinois

/s/ John C. McCarthy
For Plaintiff

MEMORANDUM DECISION—CIRCUIT COURT OF THE SEVENTEENTH JUDICIAL DISTRICT
(Case No. 80-MR-26)

STATE OF ILLINOIS
IN THE CIRCUIT COURT
OF THE 17TH JUDICIAL CIRCUIT
COUNTY OF WINNEBAGO

No. 80-MR-26

ROCKFORD LIFE INSURANCE COMPANY,
an Illinois Corporation,
Plaintiff,

—vs—

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS
and JAMES B. ZAGEL, its Director,
Defendants.

[Filed May 6, 1983]

MEMORANDUM DECISION

NATURE OF THE CASE

Complaint for Administrative Review, by Rockford Life Insurance Company (Rockford Life) against the Department of Revenue of the State of Illinois and James B. Zagel, its director (the Department) to review the Decision of the Department affirming Rockford Life's state Capital Stock Tax assessment for 1978.

RELIEF SOUGHT

Rockford Life challenges the Department's inclusion of certain Government National Mortgage Association (GNMA) securities (GINNIE MAES) and other securities in the assessment of its capital stock, and asks the Court to declare such assessment to be illegal and void.

ISSUES

Rockford Life asserts that the Department is precluded from assessing the securities in question because:

1. The securities are constitutionally immune from taxation because they are ". . . obligations of the United States . . .".

2. The Department's own Rules preclude their taxation.

3. The Department is estopped to tax these Securities for 1978 after long-standing prior determination of their exemption.

OPINION

1. The securities in question are not "obligations of the United States" within the meaning of 31 U.S.C. 742 (1976) and therefore are not constitutionally immune from state tax. *MONTGOMERY WARD INS. V. DEPARTMENT OF GOVERNMENT AFFAIRS* (1980) 89 ILL. APP. 3d 292 @ 298.

2. Notwithstanding the apparent inclusion of such securities as ". . . not subject to assessment . . ." in the "Illinois Property Tax Manual" published by the Department, that administrative agency had power to issue only such rules and regulations as are authorized by statute, and such erroneous inclusion of non-exempt as exempt property is invalid and would not preclude subsequent correction of the error and taxation of the property. *MONTGOMERY WARD INSURANCE V. DEPARTMENT OF GOVERNMENT AFFAIRS, supra* @ 302.

3. The State is not immune from application of the doctrine of estoppel, especially in its proprietary capacity. *HICKEY V. ILLINOIS CENTRAL R.R. CO* (1966) 35 ILL. 2d 427. But a strong public policy exists against estopping the State in matters relating to the collection of taxes, and the State cannot be estopped in the exercise of its powers of taxation unless necessary to prevent fraud or injustice. *AUSTIN LIQUOR MART, INC V. DEPARTMENT OF REVENUE* (1972) 51 ILL. 2d @ 5, 6. Such fraud or injustice is not demonstrated by the publication of an erroneous rule by the Department or the failure to assess taxable property in prior years.

CONCLUSION

The Complaint in Administrative Review is dismissed, the Department's final administrative decision is affirmed, and the cause is remanded to the Department for it's further proceeding.

Counsel for Defendants will prepare and submit an appropriate order for the Court's signature.

/s/ John E. Sype
Circuit Judge

May 6, 1983

DECISION OF THE ILLINOIS DEPARTMENT OF REVENUE
(Transmitted February 8, 1980)

ILLINOIS DEPARTMENT OF REVENUE

Docket Number I-18-78

IN THE MATTER OF: ROCKFORD LIFE INSURANCE COMPANY

DECISION

The Hearing was convened at 10:00 a.m., December 20, 1979 in Room 303 of the Department of Revenue, 303 East Monroe Street, Springfield, Illinois.

Appearing on behalf of the Appellant:

John C. McCarthy, Esquire

Ira L. Burleson, Esquire

Lawrence R. Matthews
Executive Vice-President
Rockford Life Insurance Company

William H. Ray, Jr.
Senior Financial Vice President
and Treasurer
Liberty National Life Insurance Co.

Dexter E. Senft
Vice-President, Fixed Income Research
The First Boston Corporation

Appearing on behalf of the Department:

Charles Groneau
Supervisor Assessment Section
Sheila Anderson
Department of Revenue

Findings:

1. Notice of this hearing was served by certified mail received on November 26, 1979 by Rockford Life Insurance Company, 526-532 West State Street, Rockford, Illinois 61101.
2. The only exemptions to the general property tax in Illinois are those required by the United States Constitution and those authorized by the Illinois Constitution and granted by statutes enacted by the Illinois General Assembly.
3. Illinois Statute provides that property of the United States is exempt, unless such property is permitted to be taxed by the United States.
4. The United States Constitution provides that a state may not levy direct taxes on a United States property without the consent of Congress. This includes certain bonds or other obligations issued by the federal government or other agencies.
5. The exemption from state and local taxes applies only to "obligations of the United States" and this requirement is construed in a highly technical manner.
6. As a general rule, obligations which are insured or guaranteed by the United States are not considered "obligations" of the United States for this purpose where the principal obligor is an individual or a corporation.
7. Obligations of federal agencies and government sponsored corporations may qualify for the exemption but it is up to Congress to specifically grant the exemptions.
8. Congress has chartered specific corporations and permitted their property to be taxed. Where

property of such organizations is encountered an examination of the charter and other related facts is necessary.

9. An examination of the charter of the Government National Mortgage Association (G.N.M.A.) indicates that Congress has not granted a specific exemption with respect to taxes imposed on principal or interest by any state or local taxing authority.

10. An examination of New Community Development bonds was that income derrived from investments in these debentures is subject to federal income taxes and carries no specific exemption with respect to any taxes imposed by any state or local taxing authority.

11. The fact that the primary obligor (Flower Mound) failed and later was paid by the United States under its guarantee is irrelevant since personal property taxes are valued as to condition as of April 1.

12. An examination of the charter for United States Government Guaranteed Ship Financing bonds guaranteed under Title XI of the Merchant Marine Act, 1936 as amended, does not show a specific exemption with respect to any taxes imposed by any state or local taxing authority.

13. G.N.M.A., New Community Development, and United States Government Guaranteed Ship Financing are not the same class as those listed in appellant's brief, Exhibit #3 "(b)" obligations guaranteed by the United States as to principal and interest of such as:

    Commodity Credit Corporation

    Federal Farm Mortgage Corporation Bonds

    Federal Housing Administration Debentures

    Tennessee Valley Authority Bonds

    each of which has a specific congressional exemption.

14. The Department of Local Government Affairs (Department of Revenue) does not have authority to grant exemptions other than as provided by the Constitution or the General Assembly.

15. Article IX § 1 of the Illinois Constitution provides that "the power of taxation shall not be surrendered, suspended or contracted away."

16. Doctrine of Estoppel does not apply in revenue cases but even if it did the Department lacks authority in granting an exemption, therefore, they cannot do by lack of action what they are forbidden to do through action.

The Capitol Stock assessment of Rockford Life Insurance Company on the "U.S. Government Obligation" attached to the Capitol Stock tax return for 1978 were not exempt from Illinois Capitol Stock tax.

The assessment is affirmed.

JAMES B. ZAGEL
Director

by: /s/ J. Thomas Johnson
J. THOMAS JOHNSON
Assistant Director

EXCERPTS FROM THE TESTIMONY OF WILLIAM H. RAY, JR. (Record, C157-C161)

* * * *

Q. Now, you spoke of the magnitude of the GNMA market. Do you have any idea of the magnitude of the GNMA market?

A. There are outstanding at this time approximately 65 billion dollars.

Q. Sixty-five billion?

A. Billion dollars of GNMA obligations.

Q. I think I asked you the question what characteristics did you consider most important. You indicated the absolute characteristic is the full faith and credit of the United States?

A. Right. Let me add one point. At the time we commit to buy GNMA's, we don't know who the issuer may be. Nobody does. You're buying a GNMA obligation. You're buying it strictly on the basis that it's a Government obligation. And until we actually pay for and get delivery of the GNMA certificate, we do not know either the issuer or the State in which they operate.

Q. Therefore, you do not consider the credit worthiness of the issuer?

A. Nobody considers the credit worthiness of the issuer.

Q. Certainly, that makes plain that you could in effect, quote, care less, end quote, who the issuer of this GNMA obligation is?

A. That's right. And I would say this, that all of the insurance companies where we know their investment process where they buy GNMA's, this is accepted practice that nobody knows whose obligation you buy until after they have been paid for and delivered.

Q. But you do know that you buy the obligation of the United States?

A. Absolutely.

Q. Now I'll ask you this. What recommendation would you have made to Rockford with respect to GNMA certificates if there had not been a full faith and credit guaranty of the United States?

A. We wouldn't buy them.

Q. Would it have made any difference in your recommendation to Rockford if you had been informed that the State of Illinois would measure its capital stock tax by including the value of GNMA certificates?

A. Absolutely.

Q. Would you elaborate upon why that would make a difference?

A. Well, in 1977 we contributed 20 million dollars to Rockford. Maybe this is the time to get this in. At the time we acquired Rockford, Rockford was a small struggling company. We acquired the company. We wanted to strengthen the company, to give its agents a better competitive chance in the insurance market. We wanted to build a company that was financially sound and strong. And in 1977 we contributed 20 million dollars to the capital of the company, and that money was invested in GNMA's. Now, had we known that there was going to be a change in the attitude toward GNMA's from prior years when there was——

Q. When they were not taxed?

A. When they were not taxed, then probably we would have had to buy U.S. Treasury, direct U.S. Treasury obligations.

Q. Or some other investment?

A. Or some other investment. But in so doing, if we had bought U.S. Treasury obligations, that would have brought less income to the company because the income from the U.S. Treasury is less than on a GNMA. Any tax on an obligation detracts from its investment merits.

Q. And that could be a relative detraction depending upon the magnitude of the tax?

A. Absolutely.

Q. What opinion, if any, do you have of the investment attractiveness of GNMA certificates should the States and other political subdivisions impose a tax upon the certificate?

A. Well, I don't think so. The GNMA program basically was a—it's a program originated by the Federal Government to allow private enterprise to provide the capital that the Government wants provided but does not want to provide on a direct basis. In other words, housing is one of the parts of our economy. And if you want to stimulate the economy, housing has been one of the areas that has been stimulated. Now, you could do this by having the Federal Government make direct financing available. But rather than use taxpayer money for it, the GNMA was one of the real beautiful devices that has come along to attract private capital but you use the Government's credit in order to make it credit worthy.

Q. Let me ask you this question another way. If a State or other taxing authority were to impose an ad valorem tax upon GNMA certificates, would such fact, the imposition of such tax, in your opinion affect the investment attractiveness of GNMA certificates?

A. Very definitely.

Q. Adversely or how would it affect it?

A. Any tax on an investment adversely affects it.

* * * *

EXCERPTS FROM THE TESTIMONY OF DEXTER E. SENFT (Record, C192-C193)

* * * *

Q. Yes. Now, what are the more pertinent characteristics of the GNMA certificates that occasion you to recommend to your customers to invest in them?

A. The GNMA certificates are similar to other passthroughs in that they have high cash flows and high yields to the investor. The GNMA's are the only passthrough certificate which are guaranteed by the U.S. Government and make them very attractive investments. They yield considerably more than other Government guaranteed obligations, Treasury's or regular agency debt.

Q. Are there any—in recommending to your clients to invest in GNMA certificates, what would you consider the most vital or important characteristic that commends your recommendation?

A. There is no single characteristic of any debt security which singles it out for all classes of investors. The primary features of GNMA's which are important to investors in general are they are Government guaranteed and they're high yield characteristics based on a high front end cash flow.

Q. Would you recommend investment in GNMA certificates without the guaranty of the United States Government?

A. If GNMA's did not have a Government guaranty, then their prices would have to change in order to make them attractive investments. At the current price at which they trade in the market, the Government guaranty is essential to make them competitive.

* * * *

REPRESENTATIVE GNMA CERTIFICATE

MORTGAGE BACKED CERTIFICATE
GUARANTEED BY
GOVERNMENT NATIONAL
MORTGAGE ASSOCIATION

251856SF

Date of Issue April 1, 1977
Single Family Mortgage Pool No. 15379
Series 2007 A Interest Rate 8.00%
Initial Payment Date May 15, 1977
Original Principal Amt. $1,018,717.20
Original Aggregate Amount of Pool $1,018,717.20
Maturity Date April 15, 2007

THE ISSUER, NAMED BELOW, PROMISES TO PAY TO THE ORDER OF:

ROCKFORD LIFE INSURANCE COMPANY
36 1695690 F

(HEREINAFTER CALLED THE HOLDER) The sum of $1,018,717 DOLS 20 CTS in principal amount, together with interest thereon and on portions thereof outstanding from time to time at the fixed rate set forth hereon, such payment to be in monthly installments, adjustable as set forth below. All monthly installments shall be for application first to interest at such fixed rate and then in reduction of principal balance then outstanding, and shall continue until payment in full of the principal amount, and of all interest accruing thereon.

FURTHER, THE ISSUER CERTIFIES: That this certificate, and each of the like securities composing the entire issue of which it is a part, is proportionately based on and backed by all the mortgages pooled by the issuer and identified collectively in the records of the Government National Mortgage Association by the mortgage pool set forth herein, all such mortgages being insured under the National Housing Act or Title V of the Housing Act of 1949, or insured or guaranteed under the Servicemen's Readjustment Act of 1944 or Chapter 37 of Title 38, United States Code; and that with respect to this certificate, the base and backing is in the proportion that the principal amount set forth bears to the total of such pool, such total being equal to the aggregate of the principal amounts of like securities composing the entire issue of which this certificate is a part, and being equal to the aggregate of the principal amounts outstanding on the mortgages composing such pool, and that the holder is the owner of an undivided beneficial interest in the pool, in the foregoing proportion.

Each of the monthly installments shall be subject to adjustment to reflect any prepayments or other early or scheduled recoveries of principal, had from time to time, under or consistent with the provisions of the mortgages composing the pool. However, the issuer shall pay to the holder, whether or not collected by the issuer, and shall remit as set forth below, monthly payments of not less than the amounts of principal being due monthly on the mortgages and apportioned to the holder by reason of the aforesaid base and backing, together with any apportioned prepayments or other early recoveries of principal and interest at the fixed rate.

The issuer shall remit to the holder all such monthly payments required under this certificate by the fifteenth (15th) day of each calendar month. Such monthly remittances shall commence before the forty-fifth (45th) day following the date of issue of this certificate, and shall continue until payment in full of all amounts owing under this certificate. All remittances shall be by check to the registered holder, and final payment shall be made only upon surrender of this certificate.

This certificate is freely and fully transferable and assignable, but only upon the books of the issuer, as to the issuer and Government National Mortgage Association. Reissues and denominational exchanges shall be made on request and presentation of this certificate at the office of Government National Mortgage Association or their co-transfer agent in New York.

Except as hereafter undertaken, this certificate does not constitute a liability of nor evidence any recourse against the issuer, since it is based on and backed by the aggregate debt of the mortgages insured or guaranteed under the laws of the United States, as set forth above, and since recourse may be had to the Government National Mortgage Association in the event of any failure of timely payment, as provided for in the guaranty appended hereto.

It is certified that this certificate is legal and regular in all respects, and is duly and validly issued pursuant to Title III of the National Housing Act, and that no rule, regulation, or other like issuance, and no contract or other agreement of either the Government National Mortgage Association or the issuer, or of both, adversely affects the rights and position of the holder as set forth in this certificate.

[Transfer Date Apr. 15, 1977 Issuer]

THE KISSELL COMPANY

GUARANTY: The undersigned, pursuant to Section 306(g) of the National Housing Act, hereby guarantees the timely payment of the principal and interest set forth in the above instrument, subject only to the terms and conditions thereof. The full faith and credit of the

United States is pledged to the payment of all amounts which may be required to be paid under this Guaranty,

[SEAL] GOVERNMENT NATIONAL
MORTGAGE ASSOCIATION

ATTEST:

/s/ Albert J. Fulner, Jr.
Secretary

/s/ David M. deWilde
President

APPELLANT'S BRIEF

(6)

No. 86-251

In The
Supreme Court of the United States
October Term, 1986

Rockford Life Insurance Company,
Appellant,

v.

Department of Revenue of the
State of Illinois, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

BRIEF FOR APPELLANT

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QUESTION PRESENTED

Whether the value of bonds of the Government National Mortgage Association ("GNMA"), carrying the unqualified pledge of the faith and credit of the United States, can properly be included in the measure of a state property tax in view of 31 U.S.C. § 742, the Supremacy Clause, and the constitutional principle of intergovernmental tax immunities.

STATEMENT UNDER RULE 15.1

James B. Zagel was a party to the action in the court below in his capacity as Director of the Illinois Department of Revenue. Douglas R. Aurand appeared as Treasurer and Ex-Officio County Collector of Winnebago County, Illinois.

STATEMENT UNDER RULE 28.1

Rockford Life Insurance Company was a wholly owned subsidiary of Liberty National Life Insurance Company at the time the tax in question was assessed and litigation began. Subsequently Rockford Life was sold to the Reliable Life Insurance Company, but Liberty National assumed the tax liability of Rockford Life and was given the right to continue this litigation in the name of Rockford. The parent of Liberty National Life Insurance Company is Torchmark Corporation in Birmingham, Alabama.

STATEMENT UNDER RULE 28.4

This appeal raises the question of the validity of an Illinois statute, as applied. Thus, 28 U.S.C. § 2403(b) may be applicable to this proceeding. A copy of this Brief for Appellant has been served on the Attorney General of Illinois.

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IN THE

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ROCKFORD LIFE INSURANCE COMPANY,
Appellant,

v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

BRIEF FOR APPELLANT

DECISIONS BELOW

The opinion of the Supreme Court of Illinois (J.A. 5) is reported in 112 Ill.2d 174, 492 N.E.2d 1278. The opinion of the Appellate Court of Illinois, Second District (J.A. 18), is reported at 128 Ill. App. 3d 302, 470 N.E.2d 596. The Trial Court's decisions (J.A. 40, 43), dated June 10, 1983, are unreported.

JURISDICTION

The opinion and judgment of the Supreme Court of Illinois was entered on April 4, 1986. (J.A. 5.) A Peti-

tion for Rehearing was denied June 2, 1986. (J.A. 17.) The notice of appeal was filed in the Supreme Court of Illinois on August 13, 1986. (J.A. 2.) This appeal was docketed on August 19, 1986, within 90 days from the date of the denial of the petition for rehearing by the Supreme Court of Illinois.

The jurisdiction of this Court rests on 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The constitutional and statutory provisions involved are set forth in the Constitutional and Statutory Appendix to the Jurisdictional Statement.

STATEMENT

This is an appeal by Rockford Life Insurance Company (Rockford) challenging the constitutionality of an Illinois personal property tax levied on its capital stock for the year 1978. Included in the measure of the tax were securities held by Rockford, with a face value of $47,-349,431.21, which were issued under a program administered by the Government National Mortage Association (GNMA), with a pledge of the full faith and credit of the United States. GNMA is a wholly owned government corporation in the Department of Housing and Urban Development. The Illinois courts rejected Rockford's argument that these securities could not be included in the value of its capital stock for purposes of computing the personal property tax.[1]

[1] In the court below, relatively small amounts of two other groups of securities were involved, issued under the New Community Act of 1968, and the Merchant Marine Act of 1936, as amended. Although appellant does not agree with the decision of the court below on the taxability of these securities, no question concerning them is raised in this Court by this appeal.

Rockford is an Illinois corporation. It is engaged in the business of selling, underwriting, and servicing insurance policies. As an integral part of its business, Rockford purchases and holds various investment securities. Among the securities it held on April 1, 1978, were the securities guaranteed by the Government National Mortgage Association, referred to above. At least since 1974, the Illinois Department of Local Government Affairs (later reorganized as the Department of Revenue; hereinafter referred to as the "Department") had treated GNMA bonds as exempt from the Illinois personal property tax. But on December 31, 1978, the Department changed its position and took the GNMA bonds into account in assessing the capital stock of Rockford at a value of $6,937,000 for the year 1978. Rockford requested a review of the assessment on the ground that the GNMA bonds were exempt from the tax as obligations of the United States. On December 21, 1979, the Department reaffirmed this assessment.

Rockford then filed a complaint for administrative review with the Circuit Court of the 17th Judicial Circuit, Winnebago County, Illinois. In the meantime, the Treasurer and ex-officio Collector of Winnebago County (the "County Collector") filed suit against Rockford to collect the taxes alleged to be due. The two cases were heard together, and on June 10, 1983, the trial court entered judgment in favor of the County Collector for $723,053.70, with costs. The Order and Judgment were affirmed by the Appellate Court of Illinois, Second District, on October 26, 1984.

Rockford then appealed to the Supreme Court of Illinois, arguing *inter alia* that inclusion of the value of the GNMA bonds in its property tax base was in violation of 31 U.S.C. § 742, the Supremacy Clause, and the constitutional doctrine of intergovernmental immunity from taxation. On April 4, 1986, the Illinois Supreme Court affirmed the decision below, explicitly rejecting Rockford's

arguments based on Federal constitutional and statutory grounds. It then denied Rockford's Petition for Rehearing on June 2, 1986.

SUMMARY OF ARGUMENT

1. It is clear, under 31 U.S.C. § 742, that the States may not impose a tax, direct or indirect, upon obligations of the United States. This rule derives from the long-established constitutional principle that Federal instrumentalities, including Federal obligations, are immune from State taxation. The prohibition against State taxation has been broadly construed to preclude any State tax which would "diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *Smith v. Davis*, 323 U.S. 111, 117 (1944).

Based on this authority, this Court has consistently held that the States may not impose taxes on federal obligations, either directly, or indirectly through a tax on the taxpayer's total property or assets. *See, e.g., American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983). Since there can be no dispute that the Illinois tax in question is a personal property tax, it cannot apply to bonds or obligations of the United States. Therefore, the GNMA certificates involved cannot be subject to the Illinois tax unless they are found not to be obligations of the United States.

2. Appellees contend that the GNMA certificates are not "obligations of the United States" within the meaning of 31 U.S.C. § 742 because they were not directly issued by the United States and the United States is supposedly not the primary obligor on the certificates. But this argument fails to recognize the nature of the legal obligation undertaken by the United States, and if accepted would recognize neither the form nor the substance of the obligations involved.

GNMA is a corporation wholly-owned by the United States, and has been entrusted with the duty of administering the "Mortgage-Backed Securities Program." This program is designed to attract private capital into the housing market. Under this program, though a private party (usually a financial institution) is nominally the issuer of the mortgage-backed securities (the GNMA certificates), it in fact merely serves as a combination broker/servicing agent for GNMA. Holders of the certificates have no rights against the private party to enforce payment of principal and interest on the certificates; their only recourse is against GNMA. GNMA is the only party bearing any obligation to the holders of the certificates, and therefore those certificates must ineluctably be considered obligations of GNMA, which pursuant to statutory authorization has pledged the full faith and credit of the United States.

3. Appellees argue that the GNMA certificates were not issued in direct exercise of the borrowing power of the United States, and therefore are not obligations falling under the protection of 31 U.S.C. § 742.

This argument, once again, is based largely on form—there would be no difference in substance between the mortgage-backed securities program involved here and a program whereby the United States would issue bonds to borrow money from the public, and then lend the proceeds to mortgage lenders, with repayment secured by mortgage pools held by the mortgage lenders. In either case, the United States would be using its credit to provide funds to the nation's housing market, in an effort to improve the availability of adequate housing for its citizens.

Moreover, even if it is conceded *arguendo* that the certificates are not issued pursuant to the borrowing power, there can be no question that they are issued pursuant to other constitutional powers, such as the power to provide for the general welfare, and the power to regulate com-

merce. The States are no more entitled to impose taxes on instrumentalities issued pursuant to such other valid powers than they are to tax the exercise of the borrowing power. The imposition of State tax on the GNMA certificates unavoidably has an adverse impact on their market value and investment attractiveness, and therefore State taxation is impermissible.

4. Appellees claim that the GNMA certificates do not satisfy the requirements of a four-part test which was supposedly enunciated in *Smith v. Davis*, *supra*, and therefore are not protected from State taxation by 31 U.S.C. § 742. But *Smith* involved accounts receivable in favor of contractors who had performed a construction contract for the United States. This Court held that an open account claim against the United States was not a "credit instrumentality" which would enjoy constitutional immunity from State taxation. In the course of reaching this decision, this Court noted that immune credit instrumentalities had historically shared four characteristics, none of which applied to the accounts receivable considered in *Smith*. But it did not state or even imply that satisfaction of all four characteristics was required in order for an obligation of the United States to be constitutionally immune from State taxation. Indeed, later decisions of this Court have considered similar issues without reference to the alleged four-part *Smith* test.

Moreover, assuming *arguendo* that *Smith* states a four-pronged test, the GNMA certificates involved here in fact would meet all four of *Smith's* requirements. No one disputes that they (i) are written instruments, (ii) bear interest, and (iii) are issued pursuant to a specific Congressional authorization which pledges the faith and credit of the United States. The courts below, however, suggested that, as the United States is acting as a guarantor rather than an issuer, the fourth requirement, that the United States make a binding promise to pay speci-

fied sums at specified dates, is not met. This is in substance only a rephrasing of the argument discussed above, to the effect that the GNMA certificates are not obligations of the United States because they were not issued by the United States, and therefore the United States is not the primary obligor, but rather just a guarantor. As shown above, this argument is incorrect as a factual matter, since the United States is the sole party which is liable to the holders of the certificates for payment of principal and interest. The fact that the United States has provided a means to meet this obligation—the underlying mortgage pools—cannot negate the fact that the United States, and it alone, is liable to pay principal and interest on the certificates.

ARGUMENT

I. THE STATES MAY NOT IMPOSE A TAX ON OBLIGATIONS OF THE UNITED STATES.

The constitutional doctrine of intergovernmental immunities, dating back to *McCulloch v. Maryland*, 4 Wheaton 316 (U.S. 1819), holds that Federal instrumentalities, including bonds and other securities and obligations, are immune from taxation by the States. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). This rule has been broadly construed to mean that the States may not impose taxes "which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." *Smith v. Davis*, 323 U.S. 111, 117 (1944).

This Court has consistently and repeatedly held that the States may not impose taxes on federal obligations, either directly, or indirectly as part of a tax on the taxpayer's total property or assets. *See American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983); *Society for Savings v. Bowers*, 349 U.S. 143 (1955); *New Jersey Realty Title Ins. Co. v. Div. Tax Appeals*, 338 U.S. 665

(1950); *Farmers and Mechanics Savings Bank v. Minnesota*, 232 U.S. 516 (1914); *In re Bank Tax Case*, 2 Wallace 200 (U.S. 1865); *People of State of New York ex rel. Bank of Commerce v. Commissioners of Taxes*, 2 Black 620 (U.S. 1863); *Weston v. City Council*, 2 Peters 449 (U.S. 1829). This is true regardless of whether the property tax in question is discriminatory.

Until the Civil War, Congress felt no need to augment the constitutional prohibition against State taxation of federal instrumentalities by statute. In light of *Weston, supra*, no statute was necessary.[3] But the Civil War necessitated a great expansion of the issuance of Government notes and securities; and it was so crucial that the credit of the United States be sustained that Congress began the practice of accompanying the sale of government securities with provisions expressly prohibiting State taxation of those obligations. *See, e.g.*, Act of February 25, 1862, c. 33, § 2, 12 Stat. 345, 346, cited in *Bank v. Supervisors*, 7 Wallace 26, 31 (U.S. 1868).

Thus, since Civil War days, there has existed statutory, as well as constitutional, prohibition of State taxation of United States obligations. During the year in dispute, that statutory prohibition was expressed in 31 U.S.C. § 742 (now codified in slightly different form as 31 U.S.C. § 3124(a)), which provided that:

> Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other non-property taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.

[3] *See Macallen Co. v. Massachusetts*, 279 U.S. 620, 623 (1929), which held that statutory immunity was "superfluous" in the case of obligations issued by Government instrumentalities, due to the constitutional doctrine of intergovernmental immunities.

The origin of 31 U.S.C. § 742 can be traced to the Act of June 30, 1864, 13 Stat. 218. *See Smith v. Davis*, 323 U.S. 111, 118 at n.9 (1944).

The tax in question, Ill. Rev. Stat., 1977, Ch. 120, Sec. 499, is undoubtedly a personal property tax. In recognition of this fact, the statute specifically exempts "property of the United States" from its coverage. *See* 1977 Ill. Rev. Stat., Ch. 120, Sec. 500.4. The Illinois courts have held that the tax was a property tax and thus could not be imposed on obligations of the United States under the United States Constitution. *See Federal Life Ins. Co. v. Dept. of Local Gov't Affairs*, 65 Ill.2d 320, 357 N.E.2d 1189 (1976). Since the tax is unquestionably a personal property tax, its application to the GNMA certificates cannot be sustained unless it is found that those certificates are not obligations of the United States. Otherwise they would be exempt from State taxation under 31 U.S.C. § 742 and the Constitution.

II. THE GNMA CERTIFICATES ARE OBLIGATIONS OF THE UNITED STATES AND THEREFORE ARE EXEMPT FROM STATE PROPERTY TAX.

Appellees contend that the certificates in question are not "obligations of the United States" within the meaning of § 742, because, they say, the bonds were not directly issued by the United States and therefore the United States is not the primary obligor. This argument fails to recognize the nature of the legal obligation running from the United States to the holders of the certificates in question, and in turn the total lack of any obligation running from the issuer or the mortgagors to the holders. Acceptance of the Appellees' position would undercut the clear purpose of Congress in enacting the statute, which was to use the credit of the United States in

order to make mortgage money more readily available for prospective home owners, at lower interest rates than would otherwise be available.

A. GNMA Is an Instrumentality of the United States.

The GNMA certificates which are the subject of this appeal were issued pursuant to the "Mortgage-Backed Securities Program," which is administered by GNMA. GNMA is a corporation wholly-owned by the United States, created pursuant to Section 801 of the Housing and Urban Development Act of 1968, Pub. L. 90-448, title VIII, § 801, codified as 12 U.S.C. § 1716b. The statute creating GNMA provided that it "will remain in the Government," *id.*, and "shall be in the Department of Housing and Urban Development." 12 U.S.C. § 1717(a)(2)(A). Thus GNMA is unquestionably an instrumentality of the United States, and its obligations are obligations of the United States. This is emphasized by the pledge of the full faith and credit of the United States to secure payment of any obligations arising under the Mortgage-Backed Securities Program. See 12 U.S.C. § 1721(g).

B. GNMA Is the Only Party Bearing an Obligation to the Holders of the GNMA Certificates.

Appellees, in an attempt to ignore both form and substance, claim that GNMA's obligation is a mere guaranty, and thus not an obligation of the United States for purposes of § 742 or the constitutional doctrine of intergovernment immunities. But this argument ignores the structure and operation of the Mortgage-Backed Securities Program.

The only obligation to the holders of the securities involved here is that undertaken by GNMA on behalf of the United States. GNMA's obligation, stated on the face of the securities, is that it—

> hereby guarantees the timely payment of the principal and interest, set forth in the above instrument, subject only to the terms and conditions thereof. The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under this guaranty.

(J.A. 56, 58.) Conversely, as regards the issuer, the GNMA bonds expressly provide (with an exception which is not relevant here[3]) that (J.A. 58)—

> . . . this certificate does not constitute a liability of nor evidence any recourse against the issuer, since it is based on and backed by the aggregate debt of the mortgages insured or guaranteed under the laws of the United States, as set forth above, and since recourse may be had to the Government National Mortgage Association in the event of any failure of timely payment, as provided for in the guaranty appended hereto.

The "Mortgage-Backed Securities Program" is designed to attract capital into the housing market. GNMA is authorized to issue securities "based on and backed by" a pool of mortgages guaranteed or insured by Federal agencies, including the Federal Housing Administration, the Veterans' Administration, and the Farmers Home Administration. It is also permitted to authorize qualifying private parties to issue such securities. GNMA is authorized to guarantee the timely payment of principal and interest on these securities. As seen above, this guarantee is backed by the full faith and credit of the United States.[4]

[3] The exception clause reads: "Except as hereinafter undertaken," which is then followed by the language quoted in the text above. The only obligation "hereinafter undertaken," is the certification of the "issuer" that "this certificate is legal and regular in all respects, and is duly and validly issued" under the federal statute, and that "no contract or other agreement . . . adversely affects the rights and position of the holder as set forth in this certificate."

[4] The GNMA Mortgage-Backed Securities Program has proven highly successful. The record in this case shows that in 1979 there

Typically, the program will operate as follows. A participating private party, generally a financial institution, acquires a pool of federally guaranteed mortgages. It then takes the pool to GNMA which enters into a Guaranty Agreement, by which it guarantees payment of principal and interest of the securities to be issued. The financial institution, in turn, agrees with GNMA to collect and transmit the payments due and received on the mortgages. GNMA then prepares the GNMA certificates, and the financial institution sells them to the public.

The only signatory of the GNMA security is the GNMA; the so-called private "issuer" never signs or otherwise takes a general obligation on the certificate. Indeed, GNMA prepares and delivers the securities. As indicated above, each certificate states on its face that the security does "not constitute a liability of nor evidence any recourse against the issuer . . .," and that the sole recourse of the security-holder is against GNMA. The GNMA certificates are treated as United States Government Securities for purposes of federal securities laws. Thus, they are exempt from the registration requirements of the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77a, *et seq.*, by virtue of section 3(a)(2) thereof (15 U.S.C. § 77c(a)(2)). *See* 12 U.S.C. § 1723c;[5] GNMA

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was outstanding "approximately 65 billion dollars" in GNMA bonds. Testimony of William H. Ray, Jr., Senior Financial Vice-President and Treasurer of Liberty National Life Insurance Company. (J.A. 52.) By the Act of May 2, 1986, 100 Stat. 412, Congress increased the limit on guaranty commitments by GNMA "by an additional $60,684,750,000 of principal." The Wall Street Journal reported this increase "boosting to 126 billion, GNMA's authority," saying that "Lower mortgage interest rates have created a rush of demand that initially depleted Ginnie Mae's guaranty authority for the current fiscal year, and has now created huge demand for the additional Ginnie Mae commitments." Wall Street Journal, May 15, 1986, p. 7.

[5] In so providing, Congress strongly implied that it considered the mortgage-backed securities to be obligations of the United

5500.1 Rev. 6, Mortgage-Backed Securities Guide, Appendix 45. Rather, the GNMA certificates are subject to the general registration and transfer requirements for government securities contained in United States Treasury Department General Regulations with respect to United States Securities. 31 C.F.R. § 306.10 *et seq.* See GNMA Mortgage-Backed Securities Guide, *supra*, Appendix 44.

Moreover, the "issuer" transfers all of its right, title, and interest in the mortgage pool to GNMA at the time it enters into the guaranty agreement. The only rights it retains are the rights to sell the securities to the public and to service the mortgage pool. See *Consolidated Mortgage & Finance Corp. v. Landrieu*, 394 F. Supp. 1284, 1287 (D.D.C. 1980); *New York Guardian Mortgagee Corp. v. Cleland*, 473 F.Supp. 422, 428-429 (S.D.N.Y. 1979). The issuer's compensation for divesting itself of the mortgage pool consists solely of the profits it makes on the

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States, regardless of whether the issuance was, in form, direct or indirect. 12 U.S.C. § 1723c states "[a]ll stock, obligations, securities, participations, or other instruments issued pursuant to this subchapter [including the GNMA certificates here at issue] shall, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities . . . ." This equation of GNMA certificates with all other United States obligations is made even more explicit in the legislative history, which states that § 1723c "makes obligations of GNMA as well as of FNMA lawful investments, and exempts all stock, obligations, securities, and other instruments issued by either from regulations by the Securities and Exchange Commission." H. R. Rep. No. 1585, 90th Cong., 2d Sess., at 129. It is clear that Congress treated all GNMA instruments as government obligations, regardless of the form of their issuance—*i.e.*, regardless of whether those securities are issued with or without the participation of a private party which is nominally the issuer. In either case, regardless of the means established to provide payment, unqualified and exclusive liability is undertaken by GNMA, pledging the full faith and credit of the United States.

sale of the mortgage-backed securities and whatever income is derived from servicing the mortgages. *Id.*

Under these circumstances, the only significant legal obligation enforceable by the holder of the bonds is against GNMA and the United States. The private issuer arranges and facilitates the transaction, but neither it nor the underlying mortgagors undertake any liability to the holders of the bonds. The obligation running from GNMA to the security holders is the same whether GNMA issues the certificates directly or issues them through a third-party private issuer. It is obvious that investors look to the credit of the United States, not that of the "issuer," in deciding whether to buy the securities.[6]

For this reason, the Court in *New York Guardian*, 473 F.Supp. 422, 429-430, *supra*, emphasized the tenuous nature of the issuer's obligations with respect to the mortgage-backed securities in finding that the issuer's role was akin to that of a common law trustee:

> Most importantly, even in the case of modified pass-through securities the issuer is not personally liable either to the security holders or to GNMA for payments due but not collected provided it diligently performs its duties as issuer . . . . The issuer's only obligation runs to GNMA, see Guaranty Agreement §4.03, and GNMA's only sanction is to terminate an issuer's status if payment is not made.

Therefore, the court held, the "issuer" was not an obligor or debtor, but served in a fiduciary capacity similar to a trustee.[7] This fiduciary role is made quite explicit in

[6] "At the time we commit to buy GNMA's, we don't know who the issuer may be. Nobody does. You're buying it strictly on the basis that it is a government obligation." Testimony of William H. Ray, Jr. (J.A. 52.)

[7] Cf. Rev. Rul. 70-544, 1970-2 C.B. 6, and Rev. Rul. 70-545, 1970-2 C.B. 8, both of which held that mortgage pools of participation certificates guaranteed by GNMA are treated as trusts for federal tax purposes.

the Mortgage-Backed Securities Guide, *supra*. Speaking of the requirement that the "issuer" assign to GNMA all right, title, and interest in and to the pooled mortgages, the Guide states:

> The assignment instruments required under this section provide further documentation of the issuer's transfer to GNMA by contractual agreement . . . of all but nominal title to the pooled mortgages upon the release of securities by GNMA. *The issuer retains nominal title to the pooled mortgages solely to facilitate servicing of the mortgages.*

Id. at 9-4, 9-5 (emphasis supplied).

Thus, the issuer's role is confined to servicing the mortgages, to which it holds only nominal title. GNMA is the sole party to which the holders of the certificates can look for payment. Under these facts, there can be no question that the certificates are obligations of GNMA for purposes of § 742 and the Constitution.

C. Application of the State Property Tax to the GNMA Certificates Would Interfere with Important Government Policies, and Is Therefore Repugnant to the Constitution and Contrary to 31 U.S.C. § 742.

In enacting the legislation which authorized the mortgage-backed securities program, Congress was acting to advance important federal policies aimed at improving the nation's housing, a policy dating back at least to "The Four Freedoms" expressed by President Franklin Roosevelt. This policy was adopted by Congress when it enacted 12 U.S.C. § 1716(a), which states that the purpose of the legislation, which includes GNMA, is to "provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." The Congressional goal of improving the nation's housing by attracting private capital into the hous-

ing market (thereby bringing down interest rates and making more money available to individual homebuyers) was served in three respects. Through the instrumentality of GNMA (i) investors would be insulated from problems inherent in the management of mortgage portfolios, (ii) their mortgage investment would have enhanced liquidity, and (iii) the full faith and credit of the United States would provide safety and security to the investors. *New York Guardian Mortgagee Corp. v. Cleland*, 473 F.Supp. 409, 411 (S.D.N.Y. 1979). See also GNMA Mortgage-Backed Securities Guide, *supra*, at 1-1:

> The Mortgage-Backed Securities Program provides a means for channeling funds from the Nation's securities markets into the housing market. The United States Government full faith and credit guaranty of securities makes them widely accepted in those sectors of the capital markets that otherwise would not be likely to supply funds to the mortgage market. The funds raised through the securities issued are used to make residential and other mortgage loans. Through this process, the program serves to increase the overall supply of credit available for housing and helps to assure that this credit is available at reasonable interest rates.

These purposes—encouraging capital investment in the housing market and assuring reasonable interest rates for such credit—are clearly important government functions. Allowing the States to tax the mortgage-backed securities, either directly or indirectly, cannot fail to make the securities less attractive and result in higher interest rates.[8] Any State tax on the value of these securities would inevitably "diminish . . . the market value or investment attractiveness of obligations issued by the

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[8] "If GNMA's did not have a Government guaranty, then their prices would have to change in order to make them attractive investments. At the current price at which they trade in the market, the Government guaranty is essential to make them competitive." Testimony of Dexter E. Senft, Vice-President of First Boston Corp. (J.A. 55.)

United States . . .," *Smith v. Davis*, *supra*, and therefore is invalid under the Constitution and under 31 U.S.C. § 742.

III. APPELLEES' CONTENTIONS ARE WITHOUT MERIT.

In the proceedings below Appellees made three basic arguments, all of which, upon examination, prove closely interrelated. The first, which has been alluded to above, was that the GNMA certificates, because formally issued by a private party, did not constitute direct United States obligations and therefore would not be protected by 31 U.S.C. § 742 or, presumably, the Constitution. As shown above, the issuer is but a manager, undertaking no obligation to the holders of the bonds, and its participation should have no effect on the substantive question involved; since GNMA is the only party obligated to the certificate holders, of necessity they are GNMA obligations. Therefore this contention of Appellees, except as it overlaps their remaining two arguments, has already been sufficiently dealt with and will not be addressed further. Their remaining arguments are (i) that the certificates were not issued in exercise of the borrowing power of the United States, and therefore for some reason are said to be subject to State taxation; and (ii) that the certificates fail to meet a four-part test for immunity from State tax which was allegedly promulgated in *Smith v. Davis*, *supra*, and therefore are subject to the property tax in question. These arguments will be dealt with in turn below.

A. Obligations of the United States, Issued in the Exercise of Constitutional Powers Other than the Borrowing Power, Are Exempt from State Taxation.

While Appellees argue that the GNMA bonds are not issued in an exercise of the borrowing power, this is not as clear as they would argue. Like the argument that the

certificates are not issued by GNMA (discussed above at pp. 10-15), this contention ignores both the form and the substance of the obligations. The mortgage-backed securities program clearly serves as a means to stimulate the flow of money into the mortgage market, and this result is achieved because the United States is using its credit to attract those funds. Whether it chooses to use that credit by directly exercising its borrowing power to acquire cash (which it then would funnel to private lenders or directly to homebuyers), or, for purposes of efficiency, chooses to use its credit to encourage private investors to funnel money into the mortgage market, is immaterial. Under either approach the United States is exercising its constitutional power to undertake financial obligations in order to make money available for the purpose of improving the Nation's housing.[9]

Be that as it may, it is clear that Federal Government obligations "issued as a means of executing constitutional powers of the government other than of borrowing money" are "as much beyond control and limitation by the States through taxation, as bonds or other obligations issued for loans of money." *The Banks v. The Mayor*, 7 Wallace 16, 25 (U.S. 1868) (double negative eliminated).[10] And it cannot be seriously disputed that the obligations undertaken by GNMA are issued in the exercise of other federal powers, specifically the Commerce Clause and the power "to provide for the . . . general Welfare of the United States" under Article I, sec. 8 of the Constitution. *See Steward Machine Co. v. Davis*, 301 U.S. 548 (1973); *Helvering v. Davis*, 301 U.S. 619 (1937).[11]

[9] It makes no difference, for purposes of this analysis, that the United States has provided an underlying source of funds which will normally cover payment of the income and principal of the bonds, that is, the payments made by the mortgagors, funneled through the persons who packaged the mortgages. There would be a similar underlying means of payment if the government had borrowed the money directly and had channeled it to the loan market through brokers and bankers under appropriate contractual arrangements. In all situations, the government has many sources of funds to meet its obligations—taxation, rents, interest receipts, sale of property, and so on. But the existence of methods of payment does not negate the basic and overriding obligation which the government has undertaken by its pledge to pay the interest and principal on the bonds—an obligation which remains in force regardless of whether the underlying mortgage pools in fact provide adequate funds.

At this date, it cannot be doubted that the Department of Housing and Urban Development is constitutional, and the Government National Mortgage Association is "in the Department of Housing and Urban Development" by legislative enactment. Thus, GNMA and the certificates are clearly instrumentalities of the Federal Government, designed to increase the commerce of the United States. The certificates derive substantial value from the government's management and guarantee.[11] Consequently, the imposition of a property tax by the State of Illinois is a direct tax on an instrumentality of the United States, and on the carrying out of a governmental

[10] *Cf. Smith v. Davis*, *supra*, which implies that powers other than the borrowing power, *e.g.* the power "to secure aid from independent contractors for necessary military and civil construction projects," are also protected under the doctrine of intergovernmental tax immunity. 323 U.S. at 115. Unlike the situation in *Smith*, imposition of State taxes in this case will clearly impair important goals of the Federal Government such as stimulating the economy and ensuring the availability of funds and lower interest rates for borrowers.

[11] *Cf.* Testimony of William H. Ray, Jr. (J.A. 54):

> ". . . housing is one of the parts of the economy. And if you want to stimulate the economy, housing has been one of the areas that has been stimulated. Now, you could do this by having the Federal Government make direct financing available. But rather than use taxpayer money for it, the GNMA was one of the real beautiful devices that has come along to attract private capital but you use the Government's credit in order to make it credit worthy."

function by the United States. Since the bonds are issued to implement a policy of the Federal Government, the tax should be wholly invalid under the principles first enunciated in *McCulloch v. Maryland*, 4 Wheaton 316 (U.S. 1819), and strongly reaffirmed in *Smith v. Davis, supra*, 323 U.S. at 117, which held that States may not impose taxes "which diminish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit."

Thus, regardless of whether the obligations were issued in a direct exercise of the borrowing power for the purpose of acquiring cash, they were issued in an exercise of constitutional functions, and accordingly may not be subject to State taxation.

B. The Four Characteristics Discussed in *Smith v. Davis* in No Way State a Definitive Test; Moreover, the GNMA Certificates in Fact Have Each of Those Characteristics.

Appellees have also argued that *Smith v. Davis*, 323 U.S. 111 (1944), states a definitive four-pronged test; if all four of its supposed requirements are not met by the GNMA certificates, they claim, those certificates will be subject to State tax.[12] An examination of *Smith* will show

[12] In addition to the alleged four-part test discussed at p. 21, below, Appellees, and the courts below, also claimed support for their position from language, contained in *Smith*, which refers to the "effort to secure necessary credit." The Illinois Supreme Court held that since the securities in question were not "related to the government's credit needs . . . [t]he government is not itself the borrower," and since the government "made the guarantees to induce others to invest in the securities . . .," the securities were not "other obligations of the United States" within the meaning of the statute. (J.A. 11.) This argument is merely a variation on the two arguments discussed previously. First, as shown above in part II, the United States is in fact the only obligor on the certificates. And, as discussed in part III-A above, it is quite clear under the

not only that the case did not state a definitive test, but that even if it did, the GNMA certificates still must be considered immune from State taxation.

Smith involved accounts receivable in favor of contractors who had built two airports for the United States Army. This Court held that an open account claim against the United States for ordinary payment for goods received and services rendered was not a "credit instrumentality" which would enjoy constitutional immunity from State taxation. As the Court noted, "the profits from a government contract stand in no preferred constitutional position so far as taxation is concerned." 323 U.S. at 116. In arriving at this conclusion, the Court observed that immune "credit instrumentalities" had historically shared four characteristics: (i) written documents, (ii) the bearing of interest, (iii) a binding promise by the United States to pay specified sums at specified dates, and (iv) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay. The accounts receivable considered in *Smith*, by contrast, had none of these characteristics. But the Court did not state or even imply that these four characteristics must all be met before an obligation of the United States would be constitutionally immune from State taxation. It concluded only that none of the prior case law was "authority for placing an open account claim under the protective umbrella of constitutional immunity." *Id.* at 115.

Subsequent decisions of this Court support the conclusion that *Smith* did not state a dispositive four-part test.

Constitution and prior decisions of this Court that the States may not impose taxes on any governmental function of the United States, whether or not that function is related to the borrowing power. *See The Banks v. The Mayor, supra.* Thus, the attempt to limit the Federal Government's immunity from State taxation to those cases in which the Federal Government is exercising its borrowing power for the purpose of acquiring cash is contrary to long-standing constitutional principles enunciated by this Court.

Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983), cited *Smith* for the general proposition that obligations of United States instrumentalities are equivalent to Treasury notes and bills under § 742, but made no reference to the supposedly determinative "four-part" *Smith* test. Surely this Court would have considered the four criteria in considerable detail if they are in fact a constitutional talisman by which such issues should be resolved.

Indeed, footnote 5 of that decision clearly shows that this Court did not view *Smith* as stating a determinative four-part test. *Memphis Bank* concerned, in addition to Treasury notes and bills, obligations of Federal Farm Credit Banks. *See* 459 U.S. at 395, n.4. This Court did not explicitly discuss whether these obligations were "other obligations" within the meaning of § 742, but since it applied § 742 in determining whether the franchise tax in question was nondiscriminatory, the Court must have concluded that these obligations were protected by § 742. This is significant because the obligations in question do not satisfy the supposed *Smith* test. For instance, the Federal Land Banks are cooperatively owned by their individual members. They issue and sell bonds to the general public. *These bonds are not in any way guaranteed by or backed by the faith and credit of the United States.* Therefore, they could not meet the fourth item of the *Smith* test. The Court was specifically informed that the United States was not liable on these obligations. See Brief of Appellees Garner and Foster at 26-27. Nevertheless, *Memphis Bank* treated these obligations as obligations which were protected by § 742.[13]

[13] In an attempt to avoid the implications of this result, the courts below made two arguments. *First*, they said that the parties stipulated that these obligations were protected by § 742 and, therefore, that the issue was not before the Court. But the stipulation referred to at page 394 of 459 U.S. in no way stated that the obligations in question were exempt. Rather, the parties merely stipulated that Appellant's federal corporate income tax returns

Even if the supposed *Smith* test were accepted as controlling, the GNMA securities would satisfy its requirements. In contrast to the open accounts considered in that case, there is no basis to contend that the GNMA certificates do not meet at least three out of the four characteristics noted in *Smith*. They are written instruments, bear interest, and are issued pursuant to a specific Congressional authorization which pledges the faith and credit of the United States.

The Illinois courts, however, have suggested that, as the United States is acting as guarantor rather than issuer, it has not made a binding promise to pay specified sums at specified dates. As shown above, this argument

listed interest on the securities in question as "interest on obligations of the United States and U.S. instrumentalities," and set out the applicable amounts for each type of security. See Parties' Joint Appendix at 36a-41a. The parties made no stipulation as to the legal characterization of these securities. At any rate, this would have been a stipulation of law which would not be binding on this Court. *See Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 114 (1939). *Second*, the courts below distinguish bonds issued by the Federal Farm Credit Banks because such bonds are specifically immunized from state taxation by separate federal statutes (see 12 U.S.C. §§ 2055, 2079, and 2134). This would be a telling point, except that this Court itself dismissed it. While noting that the separate statutory immunity existed, the Court made clear that it was relying on 31 U.S.C. § 742:

> We have no occasion to determine whether the immunity described in these provisions is broader than that otherwise provided by 31 U.S.C. § 742. We note, however, that for purposes of federal tax immunity, our cases have made no distinction between the obligations of the United States Treasury and the obligations of the Federal Credit Banks.

459 U.S. at 396, n.5. *See also Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929), at 623, 624, which held that the statutory immunity provided to Federal Farm Loan Bonds issued by Federal Land Banks was "superfluous" in light of the constitutional principles involevd. The Federal Farm Loan Bonds concerned in that case were issued under authority of Pub. L. 64-158, 39 Stat. 360, 376, the predecessor of the statute considered in *Memphis Bank*.

ignores the actual relationship between the United States, the holders of the certificates, and the issuer, for the only claim of the holder is against the United States. That the United States has provided a means which will ordinarily meet its obligation does not negate the fact that, though others have underlying liability on the mortgages, the United States, and it alone, is liable to pay the interest and principal on the bonds. But even if one should assume *arguendo* that the GNMA certificates do not share this characteristic, that assumption does not require or even support a conclusion that they are subject to State taxation under *Smith*.

The Illinois Supreme Court chose to treat the statutory and constitutional arguments advanced by Rockford as overlapping. On that basis, it applied the four-part constitutional test which it claimed was required by *Smith* in construing 31 U.S.C. § 742, and this led the court to conclude that the GNMA securities were not immune from State taxation under that statute. But the supposed four-part *Smith* test, even if accepted as such, was discussed only in the constitutional portion of this Court's decision.[14] When the Court construed § 742, it applied a different test, finding that the exemption from State tax should apply to "interest-bearing securities or obligations

[14] While *Memphis Bank and Trust Co. v. Garner*, 459 U.S. 392, 397 (1983), does suggest that § 742 is "principally" a restatement of constitutional doctrines, this is not definitive. *Smith* clearly treated the constitutional and statutory analyses as being distinct, though related. The *Memphis Bank* statement is not inconsistent with this approach. The statute is a reflection or embodiment of the Constitutional principles underlying *McCulloch* and its progeny; but nowhere is it suggested that the statute defines exclusively those obligations which may not be taxed, and in fact, prior decisions of this Court suggest that it does not. *See Macallen Co. v. Massachusetts*, 279 U.S. 620, 624 (1929) ("Of course, in respect of United States securities, the statutory exemption is superfluous."); *The Banks v. The Mayor*, *supra*. Certainly this Court's two-fold analysis in *Smith* would have been unnecessary if the statute did no more than restate the constitutional rule.

authorized by Congress, for the payment of which the credit and faith of the United States was pledged." 323 U.S. at 118. Clearly, the GNMA certificates meet this requirement, since they bear interest, were authorized by Congress, and are backed by the faith and credit of the United States. Thus, if the Illinois courts are indeed correct and the constitutional and statutory requirements are overlapping, then the requirements just stated above are in and of themselves sufficient to confer immunity, whether statutory or constitutional, without regard to the alleged four-part test.

Should there be any doubt about this conclusion, this Court made its position clear on the next page of its opinion in *Smith*. Concerning various statutes granting immunity from State taxation to Federal obligations, the Court stated "[a]ll of these related statutes are a clear indication of an intent to immunize from State taxation only the interest-bearing obligations of the United States which are needed to secure credit to carry out the necessary functions of government." 323 U.S. at 119. Congress, by enacting 12 U.S.C. § 1721(g), found that making available GNMA mortgage-backed securities was a proper and necessary utilization of the credit of the Federal Government for constitutional purposes, *i.e.*, stimulating commerce by encouraging private investment in the housing market, and thereby providing for the general welfare by making home ownership possible for more Americans. Thus, those securities clearly fall within the definition contained in *Smith*.

CONCLUSION

The GNMA certificates are obligations of the United States and are therefore exempt from the property tax sought to be imposed by Illinois. The tax puts a substantial burden on Federal housing policy, and interferes with the Congressional purpose of attracting private investors into the mortgage market. The imposition of such

tax would result in less investment of funds in the mortgage markets by insurance companies and other corporate investors. Accordingly, the Illinois tax, as applied to the GNMA certificates, should be held to be unconstitutional, and in violation of 31 U.S.C. § 742.

Respectfully submitted,

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December, 1986

APPELLEE'S

BRIEF

No. 86-251

In The

Supreme Court of the United States

October Term, 1986

ROCKFORD LIFE INSURANCE COMPANY,

Appellant,

v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, et al.,

Appellees.

On Appeal From The Supreme Court Of Illinois

BRIEF FOR COLLECTOR-APPELLEE

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SUMMARY OF ARGUMENT

1. The constitutional principle of intergovernmental tax immunity was derived from the concept that a sovereign may not tax the instrumentalities or the means of executing the powers of another sovereign. See Collector v. Day, 78 U.S. 113 (1871). The United States government derives its immunity from state taxation, in part, from the supremacy

clause and, in part, from the borrowing clause of the United States Constitution. U.S. Const. art. V1(2) and art. I sec. 8(2). Since the landmark case of McCulloch v. Maryland, 4 Wheaton 316 (U.S. 1819) this Court has consistently held that taxation by the states, of the means devised by the federal government to borrow money, is constitutionally repugnant.

As the federal government became more complex, and the need for funds increased, new and varied forms of debt securities were issued by the federal government in order to obtain the monies necessary to fund governmental functions. Often the legislation that authorized the issuance of these securities included a specific exemption from taxation. In addition, Congress passed the predecessor to 31 U.S.C. 742 which prohibited any

tax upon obligations of the United States which would "diminish in the slightest degree the market value or the investment attractiveness of the obligations issued by the United States in an effort to secure necessary credit." Smith v. Davis, 323 U.S. 111, 117 (1944). As a consequence, the constitutional and statutory exemptions from taxation are founded upon the principle that the states may not tax obligations of the federal government utilized to borrow money to fund legitimate governmental functions.

The Appellant contends that the certificates in question are "obligations of the United States" within the meaning of sec. 742 because the only recourse holders of these securities have with respect to the payment of principal and interest is against GNMA. Thus, it is the Appellant's contention that

this "obligation" or guarantee of timely payments of principal and interest exempts the holders of these securities from ad valorem taxation by the states. Unfortunately, the Appellant's limited description of these securities falls short of describing the true nature of these certificates, a description that leaves no doubt that they are not entitled to immunity from taxation.

The Government National Mortgage Association was created to shift the burden of providing funds for the civilian housing market from the federal treasury to the private sector. As a means of attracting private capital, GNMA administers the "Mortgage-Backed Securities Program" which allows private issuers (banks, brokerage companies and other financial institutions) to issue securities which are backed by a pool of federally guaranteed

mortgages. These private issuers must agree to make timely payment of principal and interest to holders of the certificates. The timely payments of principal and interest must be made, in some cases, whether or not the mortgage pools provide sufficient income. If the issuer defaults on its obligation it may lose all right, title and interest in the mortgage pool. The private issuers must pay a servicing fee to GNMA and they must also pay a fee for the guarantee made by GNMA as to the timely payments of principal and interest. It was intended by Congress that these fees make the program self-supporting.

Congress expressed that its intent in creating GNMA was to take the federal government out of the housing industry and devise a mechanism which would take the government's place. Because Congress provided an alternative means to raise funds from the

private sector that would otherwise come out of the federal treasury, it does not follow that that means is constitutionally and statutorily exempt from taxation.

2. The Appellant further contends that the imposition of an ad valorem tax on the value of these certificates held by private entities infringes on the valid governmental purpose of improving the nation's housing. This contention is without merit. This Court has never held that all instrumentalities utilized to further federal policies should be exempt from state taxation. On the contrary, this Court has held that ". . . immunities [from taxation] may not be conferred simply because the tax has an effect on the United States, ..." United States v. New Mexico, 455 U.S. 720, 734 (1982).

ARGUMENT

I. PRIVATELY ISSUED GNMA CERTIFICATES ARE NOT OBLIGATIONS OF THE UNITED STATES GOVERNMENT ENTITLED TO IMMUNITY FROM STATE TAXATION.

The doctrine of federal immunity from state taxation is a "much litigated and often confused field." U.S. v. City of Detroit, 355 U.S. 466, 473 (1958). The Appellant's attempts to characterize GNMA certificates as "obligations" of the federal government entitled to immunity from taxation, exemplifies that confusion.

The constitutional principle of federal immunity from state taxation can be traced to this Court's decision in McCulloch v. Maryland, 4 Wheaton 316 (U.S. 1819) holding that the states could not exercise control over the valid governmental functions of the federal government.

In Weston v. City Council of Charleston, 27 U.S.

449 (1829) the Court followed the reasoning of McCulloch v. Maryland in holding that obligations of the federal government are immune from state taxation.

While the Appellant reiterates the principles of federal tax immunity, Brief for Appellant at pages 7 - 9, it fails to recognize that the principle of constitutional immunity from state taxation is "aimed at protecting the borrowing power of the United States from state encroachment." Society for Savings v. Bowers, 349 U.S. 143, 143 (1955). It is the power of the United States to borrow money in order to further legitimate governmental functions that forms the basis for the federal immunity from taxation.

While the constitutional principle of federal immunity from state taxation has its roots early in our country's history, as the country grew and the need to borrow money increased, confusion over this principle caused Congress to include, along with legislation authorizing the issuance of debt securities, provisions expressly exempting these securities from state taxation.* To further complicate matters, Congress enacted the Act of June 30, 1864, 13 Stat. 218 which was the predecessor of 31 U.S.C. 742 (now codified in a slightly different form as 31 U.S.C. 3124(a)), which provided that:

* While statutory immunity may indeed be "superfluous" Macallen Co. v. Massachusetts, 379 U.S. 620, 623 (1929), such enactments were and remain a specific congressional expression that the subject securities are entitled to immunity from taxation.

> Except as otherwise provided by law, all stock, bonds, treasury notes, and other obligations of the United States, shall be exempt from taxation by or under state or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except non-discriminatory franchise or other non-property taxes in lieu thereof, imposed on corporations and except estate taxes or inheritance taxes.

This Court has held that the recognized principle of 31 U.S.C. 742 was to "prevent taxes which would dimininish in the slightest degree the market value or investment attractiveness of obligations issued by the United States in an effort to secure necessary credit." Smith v. Davis, 323 U.S. 110 (113) (1944). *

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* This Court has consistently held that the statutory exemption was "principally a restatement of the constitutional rule." Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 396 (1983).

The Appellant recognizes the fundamental theory behind the doctrine of federal immunity from state taxation, however, it fails to accept the fact that the purpose of the doctrine is to protect the borrowing power of the United States government from encroachment by state government. Consequently, in order to characterize the certificates in question in a light that would entitle them to immunity from taxation, the Appellant is forced to offer a tortured argument, valiantly attempting to show that the certificates are "obligations" of the United States government.

One need go no further than the enabling legislation itself in order to determine the intent of Congress when it authorized the "Mortgage-Backed Securities Program." In establishing the Government National Mortgage Association, Congress ex-

pressed that its purpose was "to establish secondary market facilities for home mortgages [and] to provide that the operations thereof shall be financed by private capital to the maximum extent feasible . . . ." 12 U.S.C. sec. 1716. The Government National Mortgage Association (GNMA), a wholly owned government corporation, was created to further this purpose. 12 U.S.C. sec. 1717(a). One means Congress gave to GNMA in order to attract private capital into the mortgage market was the "Mortgage-Backed Securities Program." 12 U.S.C. sec. 1721(g). This program authorized GNMA to issue securities that are backed by a pool of federally guaranteed mortgages and to authorize private companies to issue such securities. In order to make these securities more marketable, GNMA was authorized to guarantee, with the full faith and credit of the

United States, the timely payment of principal and interest which became due and owing on the securities. Id. The general purpose of establishing a system of GNMA guarantees of privately issued securities was "to foster a secondary market for home mortgages by providing a safety and liquidity not available to those investing directly in mortgages." New York Guardian Mortgagee Corp. v. Cleland, 473 F.Supp. 409, 411 (1979).

The Appellant dwells on the legal relationship which exists between GNMA and the holders of GNMA certificates, contending that this relationship raises to the level of an obligation pledging the credit of the United States in the manner entitling these securities to tax exempt status.

The Appellant characterizes the private issuer's role in the "Mortgage-Backed Securities Program"

(MBS) as merely confined to that of acting as a servicing agent for the mortgages. Brief for Appellant at 15. While Appellant has accused the Appellees of ignoring both the form and substance of these obligations, Brief for Appellant at 18, its characterization of the role of the issuer fails to describe the varied and real obligations the private issuer has with respect to the MBS program.

The MBS program works in the following manner. A private issuer applies for a commitment of guarantee authority from GNMA. The firm must meet stringent standards before GNMA provides the guarantee commitment. See 24 C.F.R. 390.3. Once the commitment is obtained, the firm must assemble a pool of mortgages that must also meet stringent standards. See 24 C.F.R. 390.7. Once the pool of mortgages has been assembled, GNMA continues to monitor the pool of

mortgages throughout the life of the agreement and requires the issuer to replace any mortgages it deems to be defective. Id. The issuer then assigns all right, title and interest in the pool to GNMA. See 24 C.F.R. 390.9. The pool of mortgages, as assigned to GNMA, is then turned over to a custodian bank in recordable but unrecorded form. Guarantee Agreement Section 3.06. * An account is established at the custodian bank into which the issuer deposits principal and interest payments it receives from the pooled mortgages. Withdrawals from these accounts are usually made only to satisfy the principal and interest demands of the securities holders. Guarantee Agreement Section 4.14, 7.03. See also New York

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* A sample of a "guarantee agreement" may be found at GNMA 5500.1 Rev. 6, Mortgage-Backed Securities Guide, App. 19.

Guardian Mortgagee Corp. v. Cleland, 373 Fed. Supp. 422, 428 (1979).

The terms of the "guarantee agreement" provide, in part, that GNMA agrees to guarantee timely payments of principal and interest while the issuer agrees to make payments of principal and interest as they are required by the terms of the securities issued. There are two types of securities that are commonly used as part of the MBS program; "straight pass-through" and "modified pass-through" securities. "Straight pass-through" securities require the issuer to make payments only as it receives payments from the pooled mortgages. Whereas, with respect to "modified pass-through" securities, the issuer is required to make payments whether or not it receives payments from the pooled mortgages. See 24 C.F.R. 390.5. "Thus, [with respect to "modified pass-through

securities"], when amounts equal to scheduled payments are not collected from pooled mortgages, the issuer has a duty to advance from his own funds amounts equal to the payments which should have been collected." New York Guardian Mortgagee Corp. v. Cleland, 473 Fed. Supp. 422, 429(1979).

In spite of Appellant's contentions, GNMA's role relative to the certificates is akin to providing a service, i.e. a guarantee, in exchange for a fee. While each GNMA certificate provides that it "does not constitute a liability of nor evidence any recourse against the issuer," see representative GNMA certificate, J.A. 58; this merely indicates that the certificate is in the nature of a non-recourse note, that is, the holder has no recourse against the issuer per-

sonally because the certificates are "based on and backed by the aggregate debt of the mortgages," Id., that make up the pool.

The fact that each certificate states that "[T]he full faith and credit of the United States is pledged to the payment of all amounts which may come due under this guarantee," J.A. at 58-59, does not mandate that the certificates be free from state taxation. GNMA's role is not that of an obligor, primarily liable on the instrument, but more that of a warrantor or surety, guaranteeing the performance of the issuer. GNMA warrants the performance of the private issuer in conveying payments of principal and interest in a timely manner. No direct obligation exists between GNMA and the holders of these certificates; any obligation between GNMA and the private holder

exists only upon default and in that event GNMA may either assume right, title and interest in the mortgage pool or stake a claim against the issuer's fidelity bond or both. See 24 C.F.R. 390.15.

A promise by the government to pay on the happening of an event that is unlikely to occur amounts to no meaningful promise at all. The promise to pay is so contingent that Appellant engages in speculation when it characterizes the guarantee as an obligation of the federal government. The guarantee is no more than a marketing tool utilized to make the securities more desirable.

Nowhere in the statutes, case law or legislative deliberation cited by the Appellant has there been any evidence that the federal legislative intent in

establishing this form of federal guarantee was to attract private capital by increasing the net return to the holders of such securities through exemptions from state taxation. Neither can that intent be implied, contrary to Appellant's contentions, from Congress' exemption of these securities from the requirements of the Securities Act of 1933, 43 Stat. 74, 15 U.S.C. Section 77 (a), et seq. If Congress had considered Mortgage-Backed Securities to be obligations of the United States, subject to immunity from taxation, it could have clearly expressed that belief by providing explicit statutory immunity from taxation. While Congress saw fit to exempt the Association from taxation, it did not do so for these securities. See 12 U.S.C. 1723 (c) (1). The fact that Appellant assumed these securities to be tax exempt does not make it so. See testimony of

William Ray, J.A. at 55.

This Court has previously refused to consider a case concerning a guarantee almost identical to that at issue in the case at bar. In S. S. Silberblatt, Inc. v. Tax Commissioner of the State of New York, 5 N.Y.2d 635, cert denied, 361 U.S. 912 (1959) the Plaintiff was a private corporation that was financing a construction project for the construction of military housing. Financing for the project was funded by mortgages guaranteed as to timely payment by the United States. When the Plaintiff attempted to record the mortgages, a mortgage recording tax was assessed. Plaintiff sought a refund of the tax claiming that the mortgages were obligations of the United States and therefore exempt from state taxation. Finding that the mortgages were subject

to the tax, the Court held that ". . . it is clear that the device employed was designated to relieve the government of its financially burdensome obligation to provide housing for its military personnel [and] at the same time avoiding increasing the national debt. It did not pledge its credit in the usual sense but merely guaranteed each periodic payment . . . ." S. S. Silberblatt, Inc. v. Tax Commissioner of the State of New York, 5 N.Y. 2d 635, 637.

The Illinois Court's characterization of GNMA's role as a guarantor with respect to these securities as opposed to that of an obligor is correct. Clearly these securities are not the type of credit obligations which should be entitled to constitutional or statutory immunity.

II. TAXATION OF GNMA CERTIFICATES DOES NOT INTERFERE WITH A GOVERNMENTAL FUNCTION ENTITLING THEM TO IMMUNITY FROM TAXATION.

While the Appellant contends that the guarantee as to timely payment of principal and interest transforms GNMA certificates into obligations of the United States entitled to constitutional and statutory immunity, it offers another theory by which it claims immunity from taxation. It is the Appellant's contention that the issuance of these certificates is a means of executing a valid constitutional power of the federal government and as such are entitled to exemption from taxation. The Appellant's reliance on The Banks v. The Mayor, 7 Wallace 16, (U.S. 1868) to support this proposition is seriously misplaced. The Banks case involves certificates of indebtedness issued to creditors of the United States for sup-

plies purchased during the Civil War. This Court held that the certificates of indebtedness were entitled to tax exempt status because it ". . . fail[ed] to perceive . . . that there is a solid distinction between certificates of indebtedness issued for money borrowed and certificates of indebtedness issued directly to creditors in payment of their demands . . . " 7 Wallace at 25. The certificates of indebtedness in The Banks case were issued for the purchase of supplies to further the war effort so they were as much entitled to exemption from taxation as if they were issued to raise money for the purchase of those supplies. The same cannot be said with regard to GNMA certificates, they are not issued by the federal government to obtain money, tangible personal property, or anything of value that is neces-

sary for the operation of the federal government so they cannot be considered credit instrumentalities that are entitled to immunity from taxation. This Court has held that "immunity may not be conferred simply because the tax has an effect on the United States, or even because the federal government shoulders the entire economic burden of the levy." United States v. New Mexico, 455 U.S. 720, 734 (1982). Simply because the Appellant, a private firm, invests in securities that are guaranteed by the federal government and issued to further a government purpose does not render those securities tax exempt. The mere fact that ". . . the economic burden on a federal function of a state tax imposed on those who deal with the federal government does not render the tax unconstitutional so long as the tax is imposed equally on the other similarly situated

constituents in the State." United States v. County of Fresno, 429 U.S. 452, 463 (1977) (see also City of Detroit v. Murray Corp., 355 U.S. 495 and U.S. v. City of Detroit, 355 U.S. 466 (1958).

A private taxpayer may enjoy the constitutional guarantee of immunity from taxation only if the taxpayer is ". . . so intimately connected with the exercise of a power or a performance of a duty by the federal government that subjecting it to taxation would be a direct interference with the functions of the government itself." James v. Dravo Contracting Company, 302 U.S. 134, 157 (1937). It could hardly be said that the Appellant ". . . stands in the government's shoes." City of Detroit v. Murray Corp., 355 U.S. 345, 503 (1958) because it owns GNMA certificates.

It is the appellant's contention that subjecting

GNMA certificates to taxation would make them less attractive and result in higher interest rates. Brief of Appellant at 16. However, the Appellant can point to no item of evidence in the record to verify its contention that taxation would diminish the investment attractiveness of these securities or that the supposed tax exempt status has any impact on their marketability. Surely if tax exempt status was to be used as a tool to market GNMA certificates, Appellant could offer a prospectus in support of that claim, but none is offered because it is the guarantee, and not tax exempt status, that makes these securities marketable. See testimony of Dexter E. Seneft, J.A. at 55. See also First National Bank of Atlanta v. Bartow County Board of Tax Assessors, _____ U.S. _____, 84 L.Ed.2d 535, 543 (1985).

CONCLUSION

GNMA certificates are not obligations of the United States in that they are not issued to raise credit for the United States and therefore subject to taxation. The Illinois Personal Property Tax, as applied to GNMA certificates, is both constitutional and not in violation of 31 U.S.C. 742.

Respectfully submitted,

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APPELLEE'S BRIEF

No. 86-251

In The

Supreme Court of the United States

October Term, 1986

ROCKFORD LIFE INSURANCE COMPANY,

Appellant,

v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, et al.,

Appellees.

On Appeal From The Supreme Court Of Illinois

BRIEF FOR APPELLEES, ILLINOIS DEPARTMENT OF REVENUE, ET AL.

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QUESTION PRESENTED

Whether Illinois can impose a capital stock tax on the assets of a private corporation, including securities guaranteed by the Government National Mortgage Association, or whether a State tax on those securities is constitutionally or statutorily prohibited by intergovernmental tax immunity.

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BRIEF FOR APPELLEES, ILLINOIS DEPARTMENT OF REVENUE, ET AL.

SUMMARY OF ARGUMENT

1. Securities guaranteed by the Government National Mortgage Association (GNMA) are not "other obligations" of the United States within the meaning of 31 U.S.C. § 3701 for two reasons: 1) there is no direct liability on the part of the Association on these certificates because the issuer of the certificates is primarily liable to the holder to pay the full amount of principal and interest;

and 2) the term "other obligations" of the United States in 31 U.S.C. § 3701 refers to interest-bearing instruments which are used by the federal government to raise revenue. Since GNMA Certificates are not issued for credit purposes, they do not come within the statutory meaning of this term.

2. State taxation of GNMA certificates is not otherwise prohibited by the doctrine of intergovernmental tax immunity. Congress has the power to expand the federal government's immunity from state taxation whenever it believes that such immunity is necessary to effectuate important federal policies. This question, being essentially legislative in character, is best left for resolution by Congress. Since Congress has not provided that GNMA Certificates are tax exempt, the courts should be reluctant to impliedly exempt this property from state taxation.

3. The non-discriminatory property tax at issue here was not imposed on federal property or a federal instrumentality; it was imposed on the capital stock of a private corporation. Since the legal incidence of the tax did not fall on the federal government, this tax was not barred by federal tax immunity.

ARGUMENT

Introduction

A. GNMA's Mortgage-Backed Securities Program

In an effort to increase and stabilize the supply of residential mortgage credit to attract a broader base of investors and capture a portion of the financial resources traditionally invested in the security and bond markets, the federal government launched two agencies, the Federal National Mortgage Association ("FNMA" or Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), whose purpose was to form the conduit which would encourage investors to place their money in securities backed by residential mortgages creating "secondary mortgage facilities" for home mortgages. 12 U.S.C. § 1716. In creating these agencies, the goal of the federal government was to supplement the development of capital from traditional portfolio lender sources.

In 1968, when Fannie Mae was rechartered as a private corporation to provide secondary market support for mortgages, the Government National Mortgage Association ("GNMA" or "Ginnie Mae") was created as a wholly-owned corporate instrumentality within the Department of Housing and Urban Development by amending Title III of the National Housing Act. *See* National Housing Act of 1934, Pub. L. No. 94-448, § 802, 82 Stat. 476 (1968), codified at 12 U.S.C. § 1717(a)(2)(A) (1976).

The Housing and Urban Development Act of 1968 amended the National Housing Act, *see* 12 U.S.C. §§ 1716-1723 (1976), by adding § 306(g), which authorized GNMA to guarantee timely payment of principal and interest on securities backed by a trust or pool of qualifying

mortgages insured by the Federal Housing Administration, or the Farmers Home Administration, or guaranteed by the Veterans Administration. *See* National Housing Act, Title III, § 306(g), 12 U.S.C. § 1721, as amended by the Housing and Urban Development Act of 1968, Pub. L. 90-448, Title VIII, § 804(b).

Through the Mortgage-Backed Securities Program ("MBS"), GNMA guaranties to investors the timely payment of principal and interest on GNMA securities, which are all backed by pools of federally-underwritten mortgages and issued by private issuers, such as mortgage lending institutions. U.S. Department of Housing and Urban Development, Government National Mortgage Association Annual Report (1984) ("GNMA Annual Report") Holders of these securities (i.e. investors) receive a "pass through" of the principal and interest payments on the pool of mortgages less amounts necessary to cover certain fees. *See* "Government National Mortgage Association Mortgage-Backed Securities Guide" (Rev. 6, 1984) ("GNMA Handbook") ch. 1, ¶ 1-1. The GNMA guaranty assures the registered holder of the security of receiving timely payments. In fact, "[i]f borrowers fail to make timely payments on the mortgages, under the modified pass-through approach, *the securities issuers must make timely payments to the registered holders, using their own resources.*" *Id.* (emphasis added)

An issuer of GNMA guaranteed mortgage-backed securities is responsible for acquiring eligible mortgages, creating a qualifying pool of mortgages to be held by a custodian, issuing the securities, arranging for the marketing of the securities, servicing the mortgages in the pool, administering the outstanding securities, "*and making full and timely payments of all amounts due to security holders.*" (emphasis added) GNMA Guide, ch. 2,

¶ 2-1. In general, the issuer is responsible "for using its own resources to cover shortfalls in amounts due to securities holders that result from mortgage delinquencies or foreclosures." *Id. See also* GNMA Guide at ch. 4, ¶ 4-2; ch. 11, ¶ 11-5.

GNMA's guaranty is explained in the GNMA Guide as follows:

> Securities to be issued under [the MBS Program] provide for the timely payment by issuers to registered security holders of principal and interest and provide for such payments to continue over the life of the pooled mortgages. *In the event that an issuer fails to make such timely payment*, or otherwise defaults in the discharge of its responsibilities, GNMA in accordance with its guaranty will continue such payments to registered security holders under the terms of an executed guaranty agreement. . . ." (emphasis added).

GNMA Guide, ch. 1, ¶ 1-3.

The Guaranty Agreement itself, which is reproduced in full in the GNMA Guide, provides that an issuer which does not remit to security holders any payment due to be made under the terms of the securities is in default. Guaranty Agreement, § 8.01.

In the event of a default, the holders of the securities "have full recourse to and as against GNMA" (Guaranty Agreement, § 7.02), and they have no recourse against the issuer. (Guaranty Agreement at § 7.01). However, "the issuer is liable to GNMA" in the event it defaults, and that liability "shall continue even in the event GNMA should declare the issuer in default under its guaranty agreement(s)." *Id.*

The first GNMA mortgage-backed securities were issued in 1970. The cumulative total of securities guaranteed by

GNMA as of September 30, 1984 exceeded $215 billion, representing financing for approximately 5.3 million housing units. 1984 GNMA Annual Report at 3. Under the MBS Program GNMA "was contingently liable" for about $175.5 billion in fiscal 1984 and $152.5 billion in fiscal 1983. *Id.* at 18. During these years, GNMA paid out $98,532 and $70,353, respectively. *Id.* Those amounts "represent less than .001 percent of the mortgage-backed securities outstanding at fiscal year end." *Id.*

In light of the foregoing, the taxpayer's argument in this case that "GNMA is the only party bearing an obligation to the holders of GNMA Certificates" (Appellant's Brief at 10-14) is not worthy of serious consideration. The issuer of the securities is primarily liable to the holders to pay all amounts due under the terms of these mortgage-backed securities. GNMA becomes liable to the holders only in the event that the issuer defaults, an event which is quite rare.

Moreover, GNMA's guaranty of the issuer's mortgage pools was never expected to "bring about an increase in the Government's total contingent liability . . . GNMA is authorized to collect a fee for its guaranty and it is intended that this program will be fully self-supporting and will operate at no cost to the [federal] government." 114 Cong. Rec. 15,236 (1968) (remarks of Sen. Bennett). Thus, GNMA's guaranty agreements impose, at best, a contingent liability upon the United States.

Finally, the taxpayer's argument that the issuer of these securities is not liable to the holder is also refuted by simply reading the face of the representative GNMA Certificate, which is reproduced at J. App. 56-59. This GNMA Certificate plainly states that:

> [t]he issuer, named below, promises to pay to the order of: Rockford Life Insurance Company 36 1690F (hereinafter called the holder) The sum of $1,018,717 Dols 20 CTS in principal amount, together with interest thereon . . . at the fixed rate set forth hereon, such payment to be in monthly installments, adjustable as set forth below.

The plain language employed on this Certificate indicates that the issuer is liable to the holder for the full amount of principal, plus interest. GNMA's liability to the holder only arises in the event that the issuer defaults in its responsibilities, in which case GNMA assumes the issuer's responsibilities. Clearly, however, the primary obligation on these Certificates runs between the issuer and the holder. GNMA's guaranty imposes only a contingent liability on GNMA—there is no direct obligation and, in most instances, the issuer will fulfill its responsibilities and GNMA will incur no liability whatsoever on these Certificates.

B. History and Purpose of Intergovernmental Tax Immunity

The doctrine of sovereign tax immunity—that both federal and state governments, their obligations, and their respective instrumentalities are immune from taxation by each other—does not arise from any express constitutional prohibition.[1] Rather, it is said to rest upon "an implied limitation on the taxing power of each, such as to forestall

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[1] State taxation of imports and exports is expressly prohibited in U.S. Const., art. I, § 10, cl. 2, which provides that:

> "no state shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws. . . ."

undue interference through the exercise of that power, with the governmental activities of the other." *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466, 477-78 (1938). Despite the fact that it is not specifically mentioned in the Constitution, this doctrine of implied immunity "is derived from the Constitution in the same sense and upon the same principle that it would be if expressed in so many words." *Callam County v. United States*, 263 U.S. 341, 344 (1923).

This Court has construed the supremacy clause[2] to mean that a state may not tax the property of the federal government, its obligations, or any of its instrumentalities, absent Congressional consent. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819). At issue in *McCulloch* was a tax which the State sought to impose on all banks, including the Bank of the United States, that were operating in Maryland but were not chartered by the State legislature. *Id.* at 317-18. Chief Justice Marshall, writing for the Court, held that Maryland's attempt to impose a discriminatory tax the Bank of the United States was unconstitutional because it undermined the supremacy of the federal government. *Id.* at 425-37. In striking down the tax Chief Justice Marshall relied, in part, upon the principle that the Constitution created two separate and distinct sovereignties, which generally are independent of each other in their powers. *Id.* Thus, he concluded that there must always be subtracted from the powers granted

[2] U.S. Const. art. VI, cl. 2 provides:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

in the Constitution the right of each sovereign to perform its functions. *Id.* In rendering this decision, Justice Marshall stressed that it did not deprive the states:

> of any resources which they originally possessed. It does not extend to a tax paid by the real property of the bank, in common with the other real property within the State, nor to a tax imposed on the interest which the citizens of Maryland may hold in this institution, in common with other property of the same description throughout the State. But this is . . . a tax on the operation of an instrument employed by the government of the Union to carry its powers into execution. Such a tax must be unconstitutional.

Id. at 430. *See also* 45 Cong. Rec. 1696 (1910). *McCulloch* thus established the principle that, absent affirmative Congressional consent, the United States government is immune from state taxation. This doctine has been consistently followed since that time. *See* e.g., *United States v. Tax Comm'n. of Mississippi*, 421 U.S. 599 (1975); *United States v. Little Lake Misere Land Co.*, 412 U.S. 580, 606-08 (1973) (Rehnquist, J. concurring); *United States v. County of Allegheny*, 322 U.S. 174 (1944). The fact that a federal instrumentality is involved rather that the government itself does not alter the application of this doctrine. In *First National Bank v. Anderson*, 269 U.S. 341 (1926), this, Court explained that instrumentalities or "agencies of the United States created under its laws to promote its fiscal policies . . . cannot be taxed under state authority except as Congress consents and then only in conformity with the restrictions attached to its consent." *Id.* at 347.

Ten years after *McColloch* this Court expanded its holding to stock issued for loans made to the United States, and held that a State tax on such stock was unconstitutional. *Weston v. City Council of Charleston*, 27 U.S. (2

Pet.) 449 (1829). In assessing the validity of this tax, the *Weston* Court noted that the power of a government to borrow money is undoubtedly an essential means by which that government can execute the objectives for which it was created. *Id.* at 467. The Court concluded that a tax on stock issued by the federal government is essentially a tax on the debt contract between the government and the stockholders. *Id.* at 469. As a result, the tax was constitutionally infirm since it impinged on the federal government's power to borrow money. *Id.*

In *Collector v. Day,* 78 U.S. (11 Wall.) 113 (1870), this Court held that Congress could not impose a tax upon the salary of a state judicial officer. The Court stated "[i]f the means and instrumentalities employed by [the federal] government to carry into operation the powers granted to it are, necessarily, and, for the sake of self-preservation, exempt from taxation by the States, why are not those by the State . . . for like reasons, equally exempt from Federal taxation?" *Id.* at 127.[3]

The fact that the federal government might likewise cripple or obstruct the operations of the state governments led to the assumption that there was a reciprocal immunity of the instrumentalities of the state governments from federal taxation. It was also quite clear, however, that this immunity was to be no broader than necessary to protect the state governments from unwarranted interference with their governmental functions. *See Board of Trustees v. United States,* 289 U.S. 48, 59 (1933), where the Court explained:

[3] The holding that the federal government could not impose an income tax on state judicial officers because they were deemed to be instrumentalities of the state was later overruled in *Graves v. New York ex rel. O'Keefe,* 306 U.S. 466, 468 (1939).

> [t]he principle . . . of the immunity of state instrumentalities from federal taxation, has its inherent limitations. . . . It is a principle implied from the necessity of maintaining our dual system of government. . . . Springing from that necessity it does not extend beyond it. Protecting the functions of government in its proper province, the implication ceases when the boundary of that province is reached.

Thus, the states can always claim an immunity from federal taxation if the tax clearly imposes an "actual and substantial, not conjectural" burden upon activities which are "indispensible to the maintenance of a state government." *Helvering v. Gerhardt,* 304 U.S. 405, 421 (1938).

Intergovernmental tax immunity will, therefore, apply to any *direct* tax upon "the means and instrumentalities employed for carrying on the operations of [federal or state] governments, for preserving their existence, and fulfilling the high and responsible duties assigned to them in the Constitution. . . ." *Collector v. Day, supra,* 78 U.S. at 125. This immunity is said to have its roots in federalism. As the Court noted in *Indian Motorcycle Co. v. United States,* 283 U.S. 570 (1930),

> * * * [t]his principle [of intergovernmental immunity] is implied from the independence of the national and state governments within their respective spheres and from the provisions of the Constitution which look to the maintenance of the dual system. (cits. omitted) Where the principle applies it is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute. (cits. omitted)

Id. at 575. *See also Board of Trustees of U. of Ill. v. United States,* 289 U.S. 48, 59 (1933).

This Court always has defined the scope of state immunity from federal taxation somewhat more narrowly because the federal government levies taxes pursuant to a specific constitutional power under the taxing clause of the Constitution, which is an enumerated power of Congress.[4] Further, federal taxation of state instrumentalities is said to be subject to greater political controls. *See*, e.g. *Helvering v. Gerhardt*, 304 U.S. 405, 412, n. 1 (1938); *McCulloch v. Maryland*, at 435-36.

In the years following *McCulloch*, the doctrine of federal immunity from state taxation experienced its greatest expansion. During this period the courts applied virtually a *per se* rule of invalidity whenever there was a showing that the state tax would place an economic burden on the federal government. As a result, this Court employed the immunity doctrine to prohibit, for example, state taxes on a federal officer's salary, *Dobbins v. Erie County*, 41 U.S. (16 Pet.) 435 (1842);[5] sales made to the United States, *Panhandle Oil Co. v. Mississippi ex rel. Knox*, 277 U.S. 218 (1928),[6] royalties from United States patents, *Long v. Rockwell*, 277 U.S. 142 (1928);[7] and income taxes on lessees of Indian lands. *Gillespie v. Oklahoma*, 257 U.S. 501 (1922)[8].

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[4] U.S. Const. art I, § 8, cl. 1 provides that:

> "[t]he Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."

[5] This decision was likewise implicitly overruled by *Graves v. New York ex rel. O'Keefe*, *supra*, at n. 3.

[6] Overruled in *Alabama v. King & Boozer*, 314 U.S. 1 (1941).

[7] Overruled in *Fox Film Corp. v. Doyal*, 286 U.S. 123, 131 (1932).

[8] Overruled in *Helvering v. Mountain Producers Corp.*, 303 U.S. 376, 387 (1938).

In attempting to define "means or instrumentalities," this Court initially had employed a very broad definition which included anything used for carrying into effect a legitimate governmental power, as long as the means were necessary to achieve a legitimate end and executed for the public good. *Dobbins v. Commissioners of Erie County*, 41 U.S. (16 Pet.) 435, 448-49 (1842). Thus, whenever the state tax imposed an "economic burden" upon the federal government, it was constitutionally impermissible. During this period of time, the intergovernmental immunity doctrine was given its most expansive scope. Immunity was accorded to all of the officers of one government from taxation by the other and it was further assumed that the economic burden of a tax imposed upon any interest derived from a government imposed a burden on that government which interfered with its function. This extensive immunity was subsequently narrowed by the Court at both the federal and state levels.

The "economic burden test" was narrowed by the Court in *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937). In *Dravo* the State wished to impose a gross receipts tax on the income received by a construction company under contract with the federal government to build locks and dams. *Id.* at 137. Under the rules developed in the decisions prior to *Dravo*, such a tax would have been unconstitutional because the contractor could have shifted the ultimate burden of the tax to the federal government. However, the *Dravo* Court redefined the economic burden test and held that where no *direct* burden is laid upon the federal government, the states can impose a nondiscriminatory tax to be collected from government contractors. *Id.* at 149-50. The fact that the imposition of the tax would increase the cost of government operations did not invalidate the tax. *Id.* at 160.

By narrowing the economic burden test to prohibit state taxation only in cases where there was a direct burden on the federal government and by permitting state taxation of income derived from property used in performing services for the federal goverment, *Dravo* adjusted the balance of state and federal interests, which had fallen so heavily in prior years in favor of immunizing the federal government from state taxation. In so ruling, the *Dravo* Court cited with approval the language from *Willcuts v. Bunn*, 282 U.S. 216 (1931), in which the *Willcuts* Court had stated:

> The power to tax is no less essential than the power to borrow money, and in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption from taxation to those subjects which fall within the general application of non-discriminatory laws, and where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any influence upon the exercise of the functions of government.

Id. at 150. The *Dravo* Court sought to balance the competing interests of the federal and state governments to insure "the essential freedom of government in performing its functions, without unduly limiting the taxing power which is equally essential to both Nation and State under our dual system." *Id.* at 157. *Dravo* thus supports the proposition that federal sovereignty is not violated by a state tax which is neither discriminatory nor laid directly upon the federal government.

Thus, taxes that financially burden federal activities but are not legally incident upon them are permitted, provided they do not discriminate against federal operations. For example, in *Alabama v. King & Boozer*, 314 U.S. 1 (1941), the defendant furnished lumber to cost-plus-fixed-fee contractors who were constructing an army camp for the

federal government. The State sought to impose a sales tax on the lumber sales, but the defendant argued that those sales were immune under the federal tax immunity doctrine. *Id.* at 6-7. The Court rejected this contention and upheld the constitutionality of this tax because the legal incidence of the tax did not fall on the government. *Id.* at 7. Under the "legal incidence test" the tax will be struck down only where the government itself is liable for payments.

Obviously, any tax directly imposed on the federal government or one of its agencies would be invalid under this doctrine. The question becomes more complex, however, when the economic burden of the tax falls upon the federal government, but the tax is not directly levied on the government. In applying the legal incidence test it is not determinative that the tax may ultimately fall upon an agency of the United States, unless the state tax "must" be passed on to the federal government, in which case the tax is unconstitutional. *First Agricultural National Bank v. Tax Commission*, 392 U.S. 339, 347 (1968). On the other hand, if the inquiry discloses that there is no such mandatory requirement, then the incidence of the tax does not fall on the federal government and the exaction is a valid one. *United States v. Tax Commission of Mississippi*, 421 U.S. 599, 610, n. 9 (1975).

Once again, however, this test has proved difficult to apply in practice and the result in a particular case has often turned on small differences in the facts of the cases, leading to opposite results in cases which were quite similar. *Compare Alabama v. King & Boozer*, *supra* and *Kern-Limerick, Inc. v. Scurlock*, 347 U.S. 110 (1954) (tax on sales made directly to federal contractor upheld in *King & Boozer*, but tax on sales made to federal government for the use of the contractor unconstitutional in

Kern-Limerick). *But see United States v. New Mexico*, 455 U.S. 720 (1982), where this Court later sustained a state gross receipts tax on a "cost plus" contractor working for the federal government despite the fact that under the applicable contractual provisions the government was the owner of the materials purchased under the contract.

If the legal incidence of a state tax does not fall directly upon the government, but falls instead upon a private entity which is practically controlled by the federal government, the courts must then consider whether this entity should be considered a federal instrumentality for purposes of tax immunity. In *United States v. County of Allegheny*, 322 U.S. 174 (1944), this Court recognized that "[t]he distinction between taxation of private interests and taxation of governmental interests, although sometimes difficult to define, is fundamental in application of the immunity doctrine as developed in this country." *Id.* at 186. The policy considerations involved in making this determination were explained by Justice Frankfurter in *United States v. Detroit*, 355 U.S. 466 (1958):

> A principle with the uninterrupted historic longevity attributable to the immunity of government property from state taxation has a momentum of authority that reflects, if not a detailed exposition of considerations of policy demanded by our federal system, certainly a deep instinct that there are such considerations, and that the distinction between a tax on government property and a tax on a third person for the privilege of using such property is not an 'empty formalism.' The distinction embodies a considered judgment as to the minimum safeguard necessary for the National Government to carry on its essential functions without hinderance from the exercise of power by another sovereign within the same territory. That in a particular case there may in fact be no conflict in the exercise of the two governmental powers is not to the point. It is in avoiding the potentialities of friction and furthering the smooth operation of complicated governmental machinery that the constitutional doctrine of immunity finds its explanation and justification.

Id. at 503-04.

Although there is no single standard utilized to determine whether a private entity is a federal instrumentality, a firm seeking such status must show an extraordinarily close relationship to the federal government. There are two major factors which are necessary to the finding that a private party is a federal instrumentality. First, it must perform a federal function. Generally speaking, the firm should not obtain a private advantage or gain from the performance of this function or it will not be entitled to claim the immunity. *See e.g., Clallam County v. United States*, 263 U.S. 341 (1923). The second factor considered by the courts in making this determination is the amount and form of financial assistance the corporation receives from the federal government. *Department of Employment v. United States*, 385 U.S. 355, 359 (1966).

While there is no simple test to determine whether a private entity is so close to the government that it has become an instrumentality, it is evident that the private entity must first overcome arduous judicial barriers. *See, e.g., Department of Employment v. United States*, 385 U.S. at 359-60 (whether entity is an "arm of the government"); *United States v. Muskegon*, 355 U.S. 484, 486 (1958) (whether corporation was "so assimilated by the Government as to become one of its constituent parts?"); *Standard Oil v. Johnson*, 316 U.S. 481, 485 (1942) (whether firm is an "integral part" of government department). This stringent standard is applied in order to protect the right of the states to tax in order to raise money to run their governments.

This Court has subsequently applied the concept of intergovernmental tax immunity in many factually distinct cases, and the pervasive policy underlying all of these decisions is to limit the scope of immunity from taxation to enable both the state and federal governments to coexist as separate and distinct governmental entities. Two competing interests are at stake whenever the courts confront the question of whether or not a state tax is barred. From the perspective of the federal government, such taxation by the several states has the potential to substantially interfere with the functions of the federal government. Conversely, because the taxing power is an essential attribute of every sovereign government, the denial of a state's right to exercise this power deprives it of a much needed source of revenue. This Court has consistently tried to balance these competing interests in determining whether a particular state tax should be invalidated.

When examining the question of whether a federal tax is barred by state tax immunity, the courts have also considered the nature of the activity which the federal government sought to tax in order to ascertain the degree of interference that such a tax would have with the function of the state government. In order to invalidate a tax which has been imposed on a state instrumentality under the doctrine of intergovernmental tax immunity, the challenged tax must also interfere with functions which are "essential" to the maintenance of the state government. *Helvering v. Therrell*, 303 U.S. 218, 233 (1938). Such a determination must be made on a case-by-case basis after consideration is given to all of the relevant facts and circumstances. *Id.* at 224-25. In its early decisions, this Court examined the activities sought to be taxed to determine whether they were essential to the state government's continued existence. *See, e.g., South Carolina v. United States*, 199 U.S. 437 (1905). The constitutionality of a tax

often turned on whether the activity sought to be taxed had a governmental, rather than a proprietary, function.

However, later this Court rejected the governmental/proprietary distinction as the sole determinant of whether an activity is, in fact, essential to the maintenance of the government. In *New York v. United States*, 326 U.S. 572 (1946), this Court found that the governmental/proprietory distinction was no longer the best means of determining whether an activity was an essential governmental function.

More recently, in *Garcia v. San Antonio Metropolitan Transit Authority*, 83 L.Ed.2d 1016 (1985), this Court rejected "as unsound in principle and unworkable in practice" a rule of state immunity from federal regulation which "turns on a judicial appraisal of whether a particular governmental function is 'integral' or 'traditional.' " *Id.* While rejecting such a rigid and formalistic approach as unworkable, the *Garcia* Court did not expressly indicate the approach which should be taken by the courts in resolving this issue. It was, however, recognized that a non-discriminatory federal tax might nevertheless so affect a state as to interfere unduly with the state's performance of its governmental functions. Both the majority and dissenting Justices in *Garcia* agreed that the essence of our federal system is that the Constitution was always intended to protect state activities by imposing limitations on the scope of federal authority to the extent necessary to preserve the independent existence of both sovereigns. *Id.* at 1032 (Blackmun, J., Opinion of the Court); *id.* at 1048 (Powell J., dissenting).

Therefore, whenever a question is raised concerning the application of the intergovernmental tax immunity doctrine, the courts must always consider the degree of interference caused by the tax or immunity from taxation

to the functioning of the state and national governments. Such a "balancing" standard is suggested by the dissent in *Garcia*, *id.* at 1041, n. 5 (Powell, J. dissenting), where the court considers both "the strength of the federal interest in the challenged legislation" as well as "the impact of exempting the States from its reach." *Id.*

In addition to the general principles outlined above, Article I, section 8 of the United States Constitution provides that "[t]he Congress shall have Power to * * * borrow money on the credit of the United States;" (Clause 2) and "[t]o make all Laws which shall be necessary and proper for carrying into Execution" this power. (Clause 18) U.S. Const., art. I, § 8. This is the constitutional source of the federal power to issue securities and other obligations of the federal government.

A correlative theory of implied constitutional immunity from state and local taxation rests upon an effort to prevent undue interference with the federal government's power to borrow money and issue obligations to secure such credit. *Hamilton Company v. Massachusetts*, 73 U.S. (6 Wall.) 632, 639 (1868). In the *Legal Tender Case*, 110 U.S. 421 (1883), the Supreme Court explained that,

> [t]he power 'to borrow money on the credit of the United States' is the power to raise money for the public use on a pledge of the public credit, and may be exercised to meet either present or anticipated expenses and liabilities of the government. *It includes the power to issue, in return for the money borrowed, the obligations of the United States* in any appropriate form, of stock, bonds, bills or notes; and in whatever form they are issued, being instruments of the national government, they are exempt from taxation by the governments of the several States.

Id. at 444 (emphasis added).

The immunity of federal obligations from state taxation was, thus, derived from both the borrowing and supremacy clauses of the federal Constitution, *Society for Savings v. Bowers*, 349 U.S. 143, 144 (1955); in 1863 this immunity was embodied in a federal statute exempting "all stocks, bonds, and other securities of the United States" from state taxation. *See* 12 Stat. 710 (1863). In 1864 this statute was broadened to also immunize from state and local taxation "other obligations of the United States." 13 Stat. 218 (1864). Comparable legislation has existed since that time to exempt federal government obligations from both state property taxes and state income taxes on their interest. Thus, a state tax which is essentially a property tax is invalid if it is assessed against a corporation without allowing the corporation to deduct an amount equal to sums invested in securities and obligations of the United States. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983).

In accordance with the constitutional principle serving as the basis for this immunity, this Court has restrictively interpreted the meaning of the term "other obligations" as that term is used in § 3701 (formerly § 742)[9] of Title 31 the United States Code. 31 U.S.C. § 3701. In *Smith v. Davis*, 323 U.S. 111 (1944), the Court applied the rule of *ejusdem generis* to restrict the meaning of this term "as referring only to obligations or securities of the same type as those specifically enumerated" in this section. *Id.* at 117. (citations omitted). The Court found that the obligations which were so enumerated all shared four common traits. They were characterized by: 1) written documents, 2) the bearing of interest, 3) a binding promise by the United States to pay specified sums at specified dates,

[9] Section 742 was replaced by § 3701 in 1959, and this section was again replaced in the 1982 reformulation by § 3124(a). *See American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 859 n. 1 (1983). Because the tax at issue in this case was levied in 1978, the pre-1982 version of this law is cited.

and 4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay. *Id.* at 115. In concluded that the "other obligations" mentioned in this section should likewise share all of these characteristics, emphasizing that:

> [t]his interpretation is in accord with the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of *obligations issued by the United States in an effort to secure necessary credit. It is unnecessary to extend such tax exemption, at least through statutory interpretation, to . . . obligations which the United States does not use or need for credit purposes. (emphasis added).*

Id. at 117.

Thus, while any state property tax on federal obligations is invalid, the courts have narrowly construed the term "obligations" in order to allow the states the broadest possible latitude in raising money to support their governments as long as the tax imposed by the states does not interfere with the federal government's power to raise funds.

Likewise, this Court has long held that non-discriminatory state franchise taxes are permissible. *See Society for Savings v. Coite*, 73 U.S. 594 (1868). Indeed, § 3701 provides an express exception for such taxes. Even these taxes will be invalidated, however, if they are found to impose "a greater burden on holders of federal property than on holders of similar state property." *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983).

In 1959 Congress amended § 3701 by adding a sentence extending the exemption to any form of taxation "that would require either the obligations, or the interest thereon" to be considered directly or indirectly in computing

the state tax. Pub. L 86-346, 73 Stat. 622. In *First Nat. Bank of Atlanta v. Bartow County Bd.*, 470 U.S. 583, 105 S. Ct. 1516, 1522 (1985), this Court found that the 1959 addition "did not broaden the scope of the exemption required [by this section] beyond that mandated by the Constitution." *Id.* at 1522.

As this Court noted in *Willcuts v. Bunn*, 282 U.S. 216, 225 (1930), to preserve the essential powers of either the state or federal government, it is not necessary to cripple the other's power to tax "extending the constitutional general application of non-discriminatory laws, . . . where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government." *See also Helvering v. Mountain Producers Corp.*, 303 U.S. 376, 385 (1937).

The states' interest which is abridged by federal sovereign tax immunity is a substantial one. Accordingly, the federal judiciary has always zealously guarded the states' power to tax. In *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), the Supreme Court cautioned that the states' power to tax can be denied "only under the clearest constitutional mandate." *Id.* at 293. Likewise, in *Metcalf & Eddy v. Mitchell*, 269 U.S. 514 (1926), the Court observed that:

> the limitation upon the taxing power of each [sovereign], so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other, and that limitation cannot be so varied and extended as seriously to impair either the taxing power of the government imposing the tax . . . or the appropriate exercise of the functions of the government affected by it.

Id. at 523-24 (citations omitted).

In light of the foregoing principles, the Illinois Supreme Court properly found in this case that GNMA securities

could be taxed because those securities were not federal obligations. Such a tax did not offend the intergovernmental immunity doctrine because it was imposed upon a private corporation, not on the federal government.

I. OBLIGATIONS GUARANTEED BY THE UNITED STATES ARE NOT "OTHER OBLIGATIONS" OF THE UNITED STATES WITHIN THE MEANING OF 31 U.S.C. § 3701.

The privately issued GNMA securities insured by GNMA are not "other obligations" of the United States within the meaning of 31 U.S.C. § 3701. First, GNMA Certificates are not "obligations" of the federal government at all—they are agreements by the issuer to pay the holder of the certificate the full amount due. GNMA guarantees the payments, however, and in the event of a default, the issuer's responsibilities will be assumed by GNMA. Nevertheless, it is the issuer which is primarily liable to the holder on these certificates. *See* Introduction to the Argument. Accordingly, GNMA Certificates could not properly be viewed as federal obligations because the federal government's liability is contingent and speculative, so there is no direct "obligation."

More fundamentally, GNMA Certificates are not federal obligations within the meaning of 31 U.S.C.A § 3701 because this statute was only a legislative codification of the federal government's constitutional immunity from state taxation, which only exempts obligations utilized to raise revenue to operate the federal government. Even assuming, *arguendo*, that GNMA were directly obligated on these Certificates, the Certificates still do not come within the meaning of the term "obligations" as that term is used in 31 U.S.C. § 3701.

In *Board of Commissioners of Montgomery County v. Eltson*, 32 Ind. 27, 1 Am. Rep. 327 (1869), the Court con-

sidered the question of whether national bank notes were exempt from state taxation. The issuance of national bank notes was approved in 1864 (*see* 13 Stat. 99, 105-06), and those notes were to "express upon their face the promise of the [bank] . . . to pay on demand." These notes were "secured by the deposit of United States bonds with the Treasurer of the United States." The Court decided that these notes were not "other obligations" within the meaning of 12 Stat. 346, § 2, because

> "these bonds are not the property of the United States, but of the national bank issuing the notes. It is true that the government in the act agrees to redeem the notes on the failure of the bank, *but the primary liability rests upon, and promise to pay comes from, the national bank. . . .*"] *Id.* at 32.

Likewise, following the rationale of the *Smith* decision, in *S.S. Silberblatt, Inc. v. Tax Commission*, 5 N.Y.2d 635, 159 N.E.2d 195, *cert. denied*, 361 U.S. 912 (1959), the Court held that a New York mortgage recording tax could constitutionally be applied to federally-insured mortgages issued by corporations on land leased by the federal government in order to provide private financing for construction of a military housing project under the National Housing Act. It was argued in *Silberblatt* that these mortgages constituted "other obligations" of the United States and they were, therefore, immune from state taxation. The New York court rejected this argument, finding that the "device employed" by the federal government was not a pledge of credit "in the usual sense," it was merely a *guaranty* of private mortgage payments. 159 N.E.2d at 196-97.

More recently, in *Provenza v. Comptroller of the Treasury*, 64 Md. App. 563, 497 A.2d 831 (1985), the taxpayer argued that her income, which was in or convertible to Federal Reserve Notes, was exempt from taxation because

Federal Reserve Notes are "other obligations" of the United States within the meaning of 31 U.S.C. § 3124(a). 497 A.2d at 832. The Court rejected this argument because "[t]he term 'obligations of the United States'" as used in this section "refers to interest bearing instruments such as United States bonds." *Id.* at 833.

The requirement that the obligations must be direct, noncontingent obligations of the federal government issued to obtain credit before they will be tax exempt under federal law is consistent not only with the doctrine of *ejusdem generis*, but also with the constitutional foundation for such immunity as necessary to preserve the federal government's borrowing power. Accordingly, an "unliquidated creditor's claim, which by itself does not bind the United States and which in no way increases or affects the public debt, cannot be said to be a credit instrumentality of the United States for purposes of tax immunity." *Smith*, 323 U.S. at 114. Likewise, a guaranty agreement in which the United States will pay only in the event of a default is not a direct obligation, nor is such an agreement entered into by the government in order to obtain money. Therefore, GNMA securities which are privately issued are not "other obligations" of the United States as that term is used in § 3701, since the guaranty of GNMA is only activated in the event that the issuer fails to fulfill its responsibilities under the Guaranty Agreement and since these documents are not issued in order to obtain funds. The primary obligation to pay both the principal and interest to the holder rests upon the issuer, which must, if necessary, make such payments out of its own funds if there has been a default on one or more of the underlying mortgages. *See* Introduction to the Argument.

In *Montgomery Ward Life v. State Department of Local Government Affairs*, 89 Ill. App. 3d 292, 411 N.E.2d 973

(1st Dist. 1980), the Department included certain GNMA mortgage-backed securities in the assessment of taxpayer's capital stock. The Appellate Court rejected the taxpayer's constitutional and statutory challenges to this tax assessment, replying upon the Court's analysis in *Smith*. First, the Court noted that GNMA mortgage-backed securities issued under 12 U.S.C. § 1721(g) differ markedly from the typical government credit instrument.

> Rather than being an obligation issued to secure money for a government purpose, Ginnie Maes were created to free government funds from the mortgage market.
>
> In addition, the Ginnie Maes are not issued by the government but by private banks.

Id., 411 N.E.2d at 978.

The Court continued:

> Only upon default in payment by the issuer is the legal title in the mortgage pool transferred to GNMA. These duties show that a private issuer is primarily liable to make the monthly payments and does not act merely as an agent of the government. The private issuer does not only channel money to GNMA but actively manages and controls the pool of mortgages backing the securities. The provision for private issuers of Ginnie Maes suggests that Congress desired to make the secondary mortgage market capable of being privately managed and getting GNMA out of the secondary market.

Id.

The Court concluded:

> The Ginnie Mae certificates satisfy all of the [*Smith*] requirements except for a binding promise to the United States to pay specified sums at specified dates. [Any obligation] is [a] contingent and speculative obligation requiring default by the issuer before it arises. Because of the probability that the trig-

gering event would never occur, the trial court apparently found that the Ginnie Maes were not constitutionally immune from a state tax. We agree that the guaranty of the United States to pay the certificates upon default by the issuer is not a binding promise so as to make the Ginnie Mae certificates constitutionally immune from tax. In addition, *we find that the Ginnie Maes were not issued by a government agency to borrow money on the credit of the United States to finance an essential governmental function but are guaranteed by GNMA to facilitate their marketability and encourage investment in them by private parties.*

Id., 411 N.E.2d at 976-77. (emphasis added)

Likewise, this Court should find that GNMA securities are taxable by the states because they are not credit obligations of the federal government—*i.e.* they are not instruments which were issued to obtain money. *Compare* 12 U.S.C. § 1720(d). Since these securities are not credit obligations, they do not implicate the borrowing power and they were never intended by Congress to be tax exempt. As the Appellate Court in *Montgomery Ward Life* correctly concluded, these securities are taxable because they were not issued in order to finance the operations of the federal government. Since they are not credit instruments, they are not "other obligations" of the United States within the meaning of 31 U.S.C. § 3701.

GNMA's guaranties of obligations of private issuers, therefore, do not constitute a binding obligation of the United States government and these securities may be subject to state taxation. GNMA only serves to guaranty these securities, which are issued by private parties. These securities are not issued in order to raise funds for the operation of the federal government, nor does the federal government fund the GNMA program. Its funding is derived, not from the federal government, but from fees

under the Guaranty Agreement. The GNMA does not possess title to the mortgage-backed securities until the speculative and conjectural event of an issuer's default. Finally, GNMA's "obligation" on these Certificates is simply a guaranty; there is no direct liability to the holder.

In the instant case the Illinois Supreme Court likewise found that GNMA Certificates were not immune from state taxation because:

> [t]he Federal government's undertaking with respect to these various obligations is a guarantee of the payment of principal and interest. The obligation imposed by that is not certain; it may or may not arise, depending on whether a default occurs. Moreover, the securities in question here do not appear to be related to the government's credit needs. The government is not itself the borrower, and it has made the guarantees to induce others to invest in the securities. We do not believe that the securities represent "other obligations of the United States" within the meaning of section 3701.

Rockford Life Ins. Co. v. Dept. of Revenue, 112 Ill. 2d 174, 492 N.E.2d 1278, 1281 (1986). Furthermore, the Illinois Supreme Court also found it significant that "Congress has the authority to provide for the exemption of these obligations but has not done so." *Id.* The Illinois Supreme Court correctly found that GNMA securities are not immune from state taxation either under 31 U.S.C. § 3701, or under the doctrine of intergovernmental tax immunity.

The absolute ban on state taxation of federal obligations, which this Court has characterized as "sweeping," *see American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983), was based upon the essential nature of such obligations to the continued existence of the federal

government. Nothing can be more essential than the power of the federal government to raise revenue, so the ability of the states to tax any aspect of this power could amount to the "power to destroy" the federal government itself. *See McCulloch; Society for Savings v. Bowers*, 349 U.S. 143, 144 (1955). Since GNMA securities are not issued in order to raise revenue however, the exemption of these securities is not "essential" to the continued existence or the proper functioning of the federal government.

Despite the enormous aggregate value of outstanding GNMA securities, amounting to $175.5 billion in 1984, *see* 1984 GNMA Annual Report at 18, the federal government's liability on these securities during that year only amounted to $98,532. *Id.* Taxpayer here argues that the federal government's contingent liability should exempt the full value of all outstanding GNMA securities from state taxation. If this argument is adopted by this Court, the states will be deprived of a major source of revenue.

Furthermore, there is no limitation upon the federal government's power to create other guaranty programs which would likewise limit the states' ability to tax other securities which simply were guaranteed by the federal government. Examples of such federal programs are presented by this case, which also involved other types of "obligations" that the taxpayer had previously argued were exempt from state taxation.[10] The Merchant Marine Act of 1936 ("MMA") establishes a Federal Ship Financing Fund "to foster the development and encourage the maintenance of . . . a merchant marine." 46 U.S.C. § 1101

[10] Taxpayer has not advanced these arguments to this Court, but a consideration of these programs as examples of other federal guaranty programs illustrates the effect a tax exemption could have on the states' ability to raise revenue.

et seq. To that purpose, the Secretary of Commerce may authorize guarantees of principal and interest on bonds issued by private obligors. *Id.* §§ 1273(a); 1274(a). (R. C338). The Secretary receives from the obligor a security interest, perfected only upon default. *Id.* § 1273(b). *See also* U.S. Code Cong. & Admin. News 3858 (1972). The program, furthermore, is self-supporting; the obligor pays a fee to the Secretary. 46 U.S.C. § 1274(e).

Likewise, the New Communities Act of 1968 (42 U.S.C. §§ 3901 *et seq.*) ("NCA") and the Urban Growth and New Community Development Act of 1970 (42 U.S.C. §§ 4501 *et seq.*) ("NCDA") attempt to "facilitate[e] the enlistment of private capital in new community development." 42 U.S.C. § 3901. These Acts permit the Secretary of Housing and Urban Development to guarantee bonds, debentures, notes and other obligations "issued by new community developers to help finance new community development projects." *Id.* § 3902. *See also Id.* § 3904(1). These programs also do not require any funding from the central government Treasury. The Secretary receives fees from the issuer for the former's guaranty. *Id.* § 3905. Indeed, the legislative history of NCA stresses that "the bill continues the emphasis of recent years of increased reliance *on private sponsorship* under our housing programs *and participation by private enterprises in financing and production of housing.*" U.S. Code Cong. & Admin. News 2874 (1968). (emphasis added).

There is no limitation upon the power of the federal government to establish programs of guaranty in which the government agrees to pay on securities in the event that a private issuer defaults. If all of these securities are absolutely exempt from state taxation, a substantial source of revenue will be placed beyond the reach of the states.

Such an interpretation would unduly interfere with the states' ability to raise funds to run their governments. This Court should, therefore, hold that the term "other obligations" of the United States in § 3701 only refers to direct credit obligations and does not encompass any contingent promise of the federal government to guaranty payment in the event that a private party defaults in its obligations to pay.

As used in § 3701, the term "other obligations" of the United States has always been limited to stocks and securities issued by the federal government to raise revenue, *see, e.g., Weston v. Charleston*, 27 U.S. 449 (1929); *Hamilton Co. v. Massachusetts*, 73 U.S. 632 (1968), or other instruments issued by the government for credit purposes. *Banks v. Mayor*, 74 U.S.16 (1869) (certificates of indebtedness issued in payment of supplies and in satisfaction of demands of public creditors). A government's power to borrow money is vital to its ability to carry out important government objectives, so this Court has long recognized that neither the federal nor the state governments should be able to tax this power. *See Mercantile Bank v. New York*, 121 U.S. 138, 162 (1887); *Weston v. City Council of Charleston*, 2 U.S. at 467.

The power of a government to impose taxes is also vital to a government's continued existence, since it is the major way in which a government raises revenue to fund its operations. *South Carolina v. Regan*, 465 U.S. 367, 386 (1984). Any limitation on the power of the states to impose taxes on private transactions has the potential to seriously interfere with the states' operations.

While the federal government may wish to perform and carry on its functions and activities free from state interference, states will continue to seek much needed revenue from a traditional source—taxation of private corporations.

To the extent that the state taxation interferes with the ability of the federal government to raise revenue, it interfers with an essential function and the courts properly will invalidate the tax under the intergovernmental immunity doctrine. Otherwise, the question of federal tax immunity is best left to Congress. Congress has the power to restrict (or broaden) constitutional tax immunity. *Graves v. New York ex rel. O'Keefe*, 306 U.S. at 597. Indeed, only Congress has the authority to determine whether and to what extent federal instrumentalities will be immune from such taxation. While it is beyond dispute that Congress may protect federal agencies from the burdens of local taxation and may, therefore, enlarge an immunity beyond that required by the Constitution, *Mayo v. United States*, 319 U.S. 441, 446 (1942), such immunity will not be lightly presumed. Accordingly, the authority for congressional immunity from taxation must be found in "clear and specific language to that effect." *United States v. United Mine Workers*, 330 U.S. 258, 272 (1947).

Where Congress has given "no intimation of any purpose either to grant or withhold immunity" from state taxation "there is no basis for implying a [congressional purpose] to exempt the federal government or its agencies from tax burdens which are unsubstantial or which courts are unable to discern." *Graves v. New York ex rel. O'Keefe*, 306 U.S. at 479. In these circumstances, the courts must "consider the nature and effect of the alleged burden, and if its appears that there is no ground for implying a constitutional immunity, there is equally a want of any ground for assuming any purpose on the part of Congress to create an immunity." *Id.* at 480.

In *Oklahoma Tax Commission v. Texas Co.*, 336 U.S. 342 (1949), this Court recognized that "the question [of] whether immunity shall be extended . . . is essentially

legislative in character." *Id.* at 365-66. Likewise, in *United States v. Detroit*, 355 U.S. 466 (1958), this Court explained that:

> [w]ise and flexible adjustment of intergovernmental tax immunity calls for political and economic considerations of the greatest difficulty and delicacy. Such complex problems are ones which Congress is best qualified to resolve.

Id. at 474. *See also Detroit v. Murray Corp.*, 355 U.S. 489, 510 (1958); *Kern-Limerick, Inc. v. Swirlock*, 347 U.S. at 127. (Douglas, J., dissenting).

If tax-exempt status is important in order to allow the federal government to achieve its goal in the GNMA program, then Congress can exempt the program from state taxation. This Court should not imply such an exemption at the behest of a private corporate taxpayer asserting the importance of the federal policies involved in this program. The taxpayer's argument in this case that the application of the State property tax to the GNMA Certificates involved here "would interfere with important government policies . . ." (Appellant's Br. at 15-16) should, therefore, not be considered by this Court, since this question is a legislative one which should be resolved by Congress. GNMA Certificates are not credit instruments, so they are not exempt from state taxation under the doctrine of intergovermental tax immunity.

II. THE TAX AT ISSUE HERE WAS PROPERLY IMPOSED BY THE STATE BECAUSE THE LEGAL INCIDENCE OF THE TAX DID NOT FALL ON THE FEDERAL GOVERNMENT OR A FEDERAL INSTRUMENTALITY.

Even absent congressional action, where the legal incidence of a state or local tax falls upon the federal gov-

ernment or a federal instrumentality, then the tax is prohibited under the supremacy clause. *See United States v. Tax Commissioner of Mississippi*, 421 U.S. 599 (1975); *New Brunswick v. United States*, 276 U.S. 555 (1928). The "legal incidence" of a tax falls directly upon the federal government if a statutory scheme for collecting a tax by its terms "unavoidably requires" as a matter of law that the fee "pass on" to the government or a goverment instrumentality. *United States v. Tax Commissioner of Mississippi*, *supra*.

This constitutional immunity from local taxation extends to governmental agencies, as well as to other federal instrumentalities. *Rohr Corp. v. San Diego County*, 362 U.S. 628 (1960). In determining whether a particular state tax is permissible, the courts are concerned "only with its practical operation, not its definition or the precise form of descriptive words which may be applied to it." *Lawrence v. State Tax Commission*, 286 U.S. 276, 280 (1932). Thus, in determining "the real nature of the tax and its effect upon the federal right asserted," *Carpenter v. Shaw*, 280 U.S. 363, 367-68 (1930), the courts must look "through form and behind labels to substance." *City of Detroit v. Murray Corp.*, 355 U.S. 489, 492 (1957).

In the instant case, the Illinois Department of Revenue had the statutory authority to "assess the capital stock, including the franchise, of all companies or associations incorporated under the laws of this State . . ." Ill. Rev. Stat. 1979, ch. 120, ¶ 1498. This tax was imposed upon Rockford Life Insurance Company, which owned a substantial amount of GNMA securities. Clearly, the statutory incidence of this tax fell upon the corporation whose capital stock was being assessed (Rockford Life Insurance Company); it did not fall upon the federal government or upon a government agency. Therefore, this tax was not

barred under the supremacy clause. Thus, while it is true, as the taxpayer argues (Appellant's Br. at 10), that GNMA is an instrumentality of the United States, this fact is irrelevant because the legal incidence of this tax does not fall on GNMA. Therefore, the taxpayer's argument that this tax "is a direct tax on an instrumentality of the United States . . ." (Appellant's Br. at 19) must be rejected.

It should also be noted that this tax was a non-discriminatory franchise tax which was imposed upon the assets of all Illinois corporations. It was never asserted that this tax impermissibly discriminated against the federal government. *See Memphis Bank & Trust Co. v. Garner*, 459 U.S. 391 (1983). Therefore, since the legal incidence of this tax did not fall on the federal government, this tax is valid "until Congress declares otherwise." *United States v. County of Fresno*, 429 U.S. 452, 460 (1977).

CONCLUSION

The Illinois tax at issue in this case was properly imposed on the full value of the taxpayer's capitol stock, including the value of GNMA securities. A tax on GNMA securities is neither prohibited by 31 U.S.C. § 3701 nor barred by federal tax immunity. The decision of the Illinois Supreme Court upholding the validity of this tax should, therefore, be affirmed by this Court.

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REPLY BRIEF

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No. 86-251

IN THE
Supreme Court of the United States
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Appellant,
v.

DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

REPLY BRIEF FOR APPELLANT

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REPLY BRIEF FOR APPELLANT

In this Reply Brief, Appellant makes brief response to certain new contentions made by Appellees and *Amici*. Moreover, as several of the briefs have emphasized the history of and Congressional purpose behind the GNMA mortgage-backed securities program, Appellant will discuss those topics in greater depth than it has previously.

I. THE HISTORY OF THE MORTGAGE-BACKED SECURITIES PROGRAM'S ANTECEDENTS, DATING BACK TO 1934, DEMONSTRATES THAT THE GNMA BONDS ARE AN INTEGRAL PART OF AN IMPORTANT FEDERAL POLICY WHICH SHOULD NOT BE BURDENED BY TAXATION.

GNMA and the mortgage-backed securities program originated in 1968, but their antecedents date back to 1934. While all segments of industry suffered under the depression, construction and related industries were particularly hard-hit. It has been estimated that there was

a 90 percent employment reduction in the residential construction field. National Emergency Council News Release, March 14, 1934.[1] Housing starts dropped from a high of 937,000 units in 1925 to 93,000 units in 1933. National Emergency Counsel News Release, May 14, 1934; H.R. Report No. 897, 81st Cong., 2nd Sess. at 56-67 (1950). Real estate markets were moribund and foreclosures were at epidemic levels. *Id.; cf. Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934). As a result, the mortgage market was in a state of virtual collapse.[2]

Previously, during the mid-and-late twenties, certain insurance companies and mortgage guaranty companies undertook to insure or guarantee mortgage debt, including the guarantee of principal and interest payments on bonds or certificates backed by pools of mortgages. Between 1930 and 1934, the experience with such mortgage-backed debt proved disastrous for both the guarantors and the holders. Hearings on H.R. 9620, *supra* at n.2, 258-259.

To deal with these and related problems, a committee appointed by President Roosevelt developed a series of proposals which were eventually embodied, with modi-

[1] The National Emergency Council News Releases cited in this brief are available at the Law Library of the Department of Housing and Urban Development as part of the legislative history of the National Housing Act of 1934, Pub. L. 73-479, 48 Stat. 1246.

[2] While a secondary mortgage market in the modern sense was unknown at the time, there had developed in the prosperous twenties rudimentary secondary markets which consisted of sales of home mortgages among local primary lenders. A lender with ample funds (*e.g.* savings deposits) would purchase previously-placed mortgages from underfunded lenders, thereby enabling the seller to make additional loans. In New York State, the mutual savings banks formed their own secondary mortgage market facility, the Institutional Securities Corporation. National Housing Act (H.R. 9620), Hearing Before Committee on Banking and Currency, House of Representatives, 73rd Cong., May 18, 1934, at 209.

fications, in the National Housing Act of 1934, Pub. L. 73-479, 48 Stat. 1246. Message of the President, May 4, 1934, 78 Cong. Rec. 8739-40.

One of the proposals[3] was to grant authority for federally-chartered, privately-owned national mortgage associations that would buy and sell mortgages, and issue bonds against them to the public at large. The basic goals of this proposal were to:

(1) provide new sources of mortgage funds through issuance of mortgage-backed bonds to investors;

(2) provide liquidity to mortgage lenders;

(3) lower the cost of mortgage funds by increasing the supply; and

(4) move mortgage funds from localities where credit was in greater supply to areas where it was in shorter supply, thereby lowering the cost of housing credit, and reducing geographic differences in such cost.

National Emergency Council News Release, May 14, 1934.

[3] Other important proposals included:

1) a program (later incorporated in title I of the National Housing Act) to insure private lending institutions against loss (up to 20 percent of the total of all loans made by each lender under the program) from residential and commercial property improvement and repair loans, whether or not secured by mortgages;

2) a program (later incorporated in title II of the National Housing Act) to insure amortized, long-term, first mortgage loans with relatively high loan-to-value ratios on owner-occupied homes and on moderate-cost rental housing projects;

3) a program (later incorporated in title IV of the National Housing Act), administered by a Federal Savings and Loan Insurance Corporation, to insure savings accounts, thereby providing building and loan (savings and loan) associations and their shareholders with a benefit that the FDIC accorded to commercial banks and their depositors.

While this proposal was embodied in Title III of the National Housing Act of 1934, Pub. L. 73-479, 48 Stat. 1246, the program was not a success. In fact, no private mortgage association was ever established under the program. In 1948, authority for the program was repealed. Pub. L. 80-864, 62 Stat. 1206.

In contrast to such privately-owned mortgage associations, the Federal National Mortgage Association ("FNMA") was chartered on February 10, 1938. FNMA's function originally was to purchase mortgages guaranteed by the Federal Housing Administration. It would thus create a national secondary market for mortgages, thereby channeling Federal Government credit to the housing industry. However, FNMA did not issue mortgage-backed securities, as envisioned in the original plan.

In 1954, FNMA was reorganized under a new charter, and was charged with three major classes of functions: (1) the management and liquidating functions of servicing and disposing of its then-existing mortgage portfolio; (2) the special assistance functions of helping to finance housing designated by the Government as serving special public purposes or of helping to ease the effects on the housing market of unfavorable economic conditions; and (3) the secondary market function of providing liquidity for the residential mortgage market. Pub. L. 83-560, § 201, 68 Stat. 590, 612. Under the 1954 Act, FNMA became a mixed-ownership Government corporation. The management and liquidating and special assistance functions were to be operated exclusively for the account of the Federal Government and were to be financed largely with funds borrowed from the United States. The secondary market function was to be separately accounted for and financed primarily with funds borrowed in the private market. The obligations arising from such borrowings were not guaranteed by the United States.

In 1968, FNMA was partitioned into two new corporations, each a successor to a portion of the original FNMA. Pub. L. 90-448, § 801 et seq., 82 Stat. 476, 536. One of these, the Government National Mortgage Association ("GNMA") remained in the Department of Housing and Urban Development to carry out the Governmental management and liquidating functions and the special assistance functions of the predecessor FNMA. The other corporation retained the Federal National Mortgage Association name and the assets related to the self-supporting secondary market operations. The Federal Government's ownership interest in the new FNMA was terminated on September 30, 1968. Thus, GNMA remained in the Government and succeeded to the governmental functions of its predecessor, while FNMA left the Government.

In the same Act, GNMA was authorized to conduct the mortgage-backed securities program at issue here—a program similar to that originally enacted, but never implemented, in 1934. The reasons behind the program remained virtually unchanged. *See A Study of Mortgage Credit*, Subcommittee on Housing and Urban Affairs, Committee on Banking and Currency, United States Senate, 90th Cong., 1st Sess., May 22, 1967. That study consists of numerous proposals by the Administration, Government agencies, lenders, builders, and others concerned with national housing policy and the availability of adequate mortgage funds. The submissions made there repeatedly suggested creation of a mortgage-backed securities program. *Id.* at 127-128; 147-148; 202; 254; 297-298; 307-309; 329-330; 416; 431. Several of these comments noted the desirability of a Federal Government guarantee of such securities, *e.g.* at pp. 202, 329, and Congress soon adopted such a program, along with the federal guarantee, in 1968.

Perhaps learning from the experience of the thirties, Congress clearly provided that administration of that program would be by an agency *within* the Federal Gov-

ernment, on a national basis. (*Cf. Id.* at 202, 329-330) This, along with the pledge of the full faith and credit of the United States guarantee of the certificates, is the main difference between the current program, and the 1934 proposal. Based on the prior disastrous experience, both provisions were essential to establish a successful secondary market program. Thus, far from being an afterthought, or a relatively unimportant facet of the program, the full faith and credit guarantee of the United States is of the utmost importance to the entire program, and the key to its success. It is therefore a crucial part of the national housing policy. Without the use of the Federal Government's credit, the program probably would not be viable. Accordingly, under both constitutional and statutory law, it is impermissible for the States to impose taxes on the instrumentalities used to provide that credit—the GNMA certificates.[4]

This is underscored by the fact that a primary reason for a national secondary mortgage market is to prevent local and regional economic dislocation. Unlike many other segments of our economy, home construction is by its very nature a local enterprise. One problem which has always plagued the industry is the tendency to geographical credit discrepancies. This problem was recognized at least as early as 1934, and has continued to be addressed over the years. *See, e.g., Federal Role in Urban Affairs*, Hearings Before the Subcommittee on Executive Reorganization, Senate Committee on Government Operations, Appendix to Part 1, 89th Cong., 2nd Sess. at 42, 46 (1966). Allowing the various States and localities to impose property taxes on the mortgage-

[4] As discussed in previous submissions, the form by which the United States chooses to utilize its credit to advance its constitutional purpose should have no bearing on its immunity from a State tax imposed on the use of such credit. *See Detroit v. Murray Corp.*, 355 U.S. 489, 492 (1957) ("[I]n determining whether these taxes violate the Government's constitutional immunity we must look through form and behind labels to substance.")

backed securities is therefore directly contrary to the Congressional purpose of nationalizing and rationalizing mortgage credit through the use of secondary market facilities. Upholding the Illinois tax in question would make the economic consequences to GNMA certificate holders turn on the accident of their location, leading to lesser rather than greater national uniformity. Indeed, this fact is well illustrated by the California Franchise Tax Board's candid admission that it changed its previous administrative position, that the securities were tax exempt, as a result of the prior Illinois litigation. *See* Brief of the California Franchise Tax Board at 2.[5] Such increased incidence of local taxes cannot help but interfere with the national housing policy. Despite arguments to the effect that such interference is incidental or minimal, this Court has long held that the principle of intergovernmental immunity "is not affected by the amount of the particular tax or the extent of the resulting interference, but is absolute." *Indian Motocycle Co. v. United States*, 283 U.S. 570, 575 (1930).

II. THE ARGUMENTS CONTAINED IN THE BRIEFS OF APPELLEES AND AMICI ARE WITHOUT MERIT.

A. The GNMA Certificates Are Obligations of the United States.

A recurring theme of Appellees' and others' briefs is that the GNMA securities are not direct obligations of the United States because the private issuer has the primary obligation to pay principal and interest. For example, Appellee Department of Revenue quotes the representative certificate (J.A. 56-59) to the effect that "The

[5] It also appears that at least one other State, Maryland, changed its administrative position that interest on GNMA bonds was tax exempt as a result of the prior Illinois litigation. Comptroller of the Treasury of the State of Maryland, Income Tax Division, Memorandum Release No. 28 (Jan. 1, 1984).

issuer, named below, promises to pay . . . principal amount, together with interest thereon" but neglects to quote subsequent language stating that "this certificate *does not constitute a liability of nor evidence any recourse against* the issuer." *Id.* (emphasis supplied). Query how an issuer can be "primarily" liable when it is, indeed, subject to *no* liability.

Several of the briefs attempt to argue that the United States is not obligated on the certificates because it has protected itself by various mechanisms, and these mechanisms historically have protected it from any significant loss. (*See, e.g.,* Brief of Department of Revenue at 6; Brief of Franchise Tax Board at 11). This is totally irrelevant. The United States is obviously the *only* party bearing any enforceable obligation to the holders of the certificates. That it has in its wisdom chosen to meet that obligation through protective, and historically highly successful, mechanisms has no bearing on the question of which party is liable to the holders.

As if it were not enough that the Appellees have argued that, notwithstanding the plain language of the certificates, the certificates are obligations of the issuer rather than the United States, two of the Amici go so far as to suggest that it is the underlying mortgagors to whom the holders of the certificates look. *See* Brief of California Franchise Tax Board at 8; Brief of United States at 12. Undoubtedly the mortgagors are indebted on the underlying mortgages, but they bear absolutely no obligation on the certificates and have no relationship to the holders. Thus the attempt to rely on the underlying obligation of the mortgagors is quite unwarranted. The mortgages as such were unmarketable. Indeed, it was because of that fact that GNMA was brought into existence and supported by United States Government credit. Similarly, it is difficult to respond to the Franchise Tax Board's attempt to distinguish a guarantee of timely payment from a guarantee of payment, because

such attempted distinction is ill-founded and at best irrelevant. The central fact, undisputed in the record, is that the purchaser or holder of the GNMA security looks only to the credit of the United States in evaluating his investment; he is concerned with neither the identity of the issuer nor the underlying mortgagors, and is ordinarily unaware of them. Testimony of William H. Ray, Jr. (J.A. 52).

B. *Smith v. Davis* in no Way Precludes Immunity From State Tax.

Smith v. Davis, 323 U.S. 111 (1944), has been extensively discussed by Appellant in its prior submissions to this Court. For purposes of this Reply Brief, Appellant would only make the following point.

The role of the four factors mentioned in *Smith v. Davis* has been unduly exaggerated; *Smith* simply noted that the accounts receivable in question satisfied none of four factors which previous immune credit instrumentalities had possessed. Nothing in *Smith v. Davis* or any later decision of this Court states that a Federal obligation, in order to be immune from State tax, must meet all four items of the supposed four-part test as advocated by Appellees. Moreover, assuming *arguendo* that the GNMA certificates are not "direct" obligations of the United States because of the guaranty feature, application of the rule of *ejusdem generis* invoked by Appellees would in fact seem to require immunity for the certificates here. The certificates are interest-bearing financial instruments, readily traded on national markets, and purchased by investors because they offer a secure rate of return. Thus, they are virtually identical to treasury notes and other such instruments as far as a purchaser or holder is concerned, and from the purchaser's perspective have no similarity to the open account claims concerned in *Smith.* (This is true regardless of whether the certificates are "bonds" in the technical sense of the

term, as the United States questions in a rather quibbling footnote at page 10 of its brief). *Cf. Provenza v. Comptroller*, 64 Md. App. 563, 497 A.2d 831, 833 (1985), cited in Brief for Appellee Department of Revenue, at 25. That case held that Federal Reserve Notes—money—were not "other obligations" within the meaning of 31 U.S.C. § 3124(a) because they were not "interest bearing instruments such as United States bonds." In contrast, the GNMA certificates obviously are interest bearing obligations.

C. It Is Immaterial That the Legislation Authorizing the Mortgage-Backed Securities Program Does Not Specifically Provide That Those Securities Are Immune.

This point has been alluded to in Appellant's prior submissions to this Court. Suffice it to say that the Constitution and 31 U.S.C. § 742 compel a conclusion that the certificates are immune. As stated in *Macallen Co. v. Massachusetts*, 279 U.S. 620 (1929), any additional statutory provision would be superfluous. In this regard, 12 U.S.C. § 1719(b) and (e) (cited by *Amici* National Governors' Association *et al.* in their brief at n.9, p. 18) actually support this conclusion. In those provisions, Congress found it necessary for FNMA (a privately-owned entity which in contrast to GNMA does not have the power to pledge the full faith and credit of the United States) to state specifically on the face of its obligations that they do *not* constitute obligations of the United States. Thus, it is if anything more reasonable to conclude that the silence of Congress concerning the GNMA certificates—carrying, as they do, a pledge of the full faith and credit of the United States—indicates that they *are* to be considered obligations of the United States, than it would be to adopt the Appellees' position.

D. The Discussion of Indirect Versus Direct Incidence of Tax Contained in Appellee Department of Revenue's Brief Has No Bearing on This Case.

Pages 34 through 36 of the Department of Revenue's Brief argue that, because the legal incidence of the tax at issue did not fall on GNMA or the United States, the tax should be upheld. While Appellee's brief seems to present an accurate discussion of that area of the law, that discussion has no relevance to this case. Appellant has never claimed that the statutory incidence of the tax fell on anyone other than itself; indeed, if such were the case it would not be engaged in this litigation. But this undisputed fact has no bearing on whether obligations of the United States may be taxed. *See, e.g., American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), which struck down a State tax even though its legal incidence was clearly on the taxpayer bank. Both the Constitution and 31 U.S.C. § 742 make it clear that a State property tax may not be imposed on obligations of the United States regardless of who bears the immediate burden of the tax.

E. The "Slippery Slope" Arguments Advanced by the United States Are Without Foundation.

In his amicus brief, the Solicitor General beclouds the issue here by suggesting a parade of horribles. In particular, he contends that a decision in favor of the petitioner on the *property* taxation question involved here would require the conclusion that the interest received by the holder of a GNMA bond is not subject to State *income* taxation. The response to this suggestion may be summarized as follows:

1. The income tax question is not involved in this case. This is a property tax case. The factors bearing on the validity of an income tax, and the arguments available, might well be different from those involved here.

2. Even if the income tax question involved the same considerations as those in this case, the impact of such a decision is not nearly as great as the Solicitor General suggests.

The revenue loss to the States would not be nearly as great as the United States implies, even if the interest on the GNMA certificates were held to be tax exempt. Many States do not impose corporate income taxes, but rather tax corporations by some alternative means such as a nondiscriminatory franchise tax. Thus, whether or not the interest on the GNMA certificates were held to be tax exempt, that holding would not seriously affect revenues of such States. Further, a large percentage of GNMA certificates is held by tax exempt institutions such as charities or pension funds. There would be no loss of State revenues, even in those States which impose an income tax, with respect to these bonds.

Further, the United States says that, if the Illinois tax is held not to apply to GNMA bonds, then a "myriad" of federally guaranteed programs will suddenly be immune from State taxation. As discussed in Appellant's prior submissions, however, the GNMA certificates involve far more than a guarantee in the usual sense of the word. The GNMA program is unique in history and in structure, and a decision in favor of Appellant need not require tax immunity for more conventional federal guarantee programs.

For instance, contrary to the United States' assertion, the FHA mortgage insurance program cannot be compared to the GNMA mortgage-backed securities program. The mortgagor on an FHA-insured mortgage remains primarily and personally liable on that mortgage, unlike the issuers involved here. The lender is required to foreclose, assign the mortgage to FHA, or otherwise collect from the property securing the mortgage before the FHA insurance comes into play. The lender may be required to forebear its right to foreclose for a pre-

scribed period. Further, in order to receive the benefit of the insurance, the mortgagee must convey the foreclosed property to the Secretary, and assign all claims against the mortgagor to the Secretary. Moreover, the mortgagee is reimbursed only for the "value of the mortgage," defined as unpaid principal amount, plus partial reimbursement of various out-of-pocket expenses, but not including (in most instances) unpaid interest; and the insurance benefit may be paid, at the option of the Secretary, in long-term debentures rather than cash. *See generally* 12 U.S.C. §§ 1709-1710; 24 C.F.R. § 203. This is in sharp contrast to the simple obligation undertaken by GNMA to make full and timely payment of all principal and interest due and owing to the certificate holder in the event of a default. The whole objective of the GNMA operation is to make that obligation available to the holder, with the resulting benefits of marketability and liquidity.

3. Many States do not impose a property tax on intangibles. Indeed, Illinois has already repealed the tax involved here. Moreover, Illinois did not at first undertake to tax GNMA bonds. That was an afterthought, a change made *after* the bonds here were purchased by the Appellant. Similarly, as shown in the amicus brief of the State of California (p. 2), that State undertook to tax GNMA bonds only after the Illinois Court of Appeals had sustained such a tax in *Montgomery Ward Life Ins. Co. v. Dep't of Local Gov't Affairs*, 89 Ill. App. 3d 292, 411 N.E. 2d 973 (1st Dist. 1980). Thus, a holding limited to the facts of this case would not have nearly the impact feared by the Solicitor General.

4. There can be no doubt that a significant portion of the *value* of GNMA bonds is the direct result of the Government's obligation. In this case, the State of Ilinois has undertaken to tax the *entire value* of the GNMA bonds, which means that the State is seeking here to

impose a tax on an appreciable amount of value which is the direct consequence of (a) the Government's guaranty, and (b) the Government's clear policy of facilitating and encouraging investment in housing. The State has made no effort to limit its tax to that portion of the value which is independent of the Government's guaranty.

5. Moreover, the Congress has spoken, in broad and unqualified terms, when it provided in 31 U.S.C. § 742 that "obligations of the United States shall be exempt from taxation by or under state or municipal or local authority"—most recently reenacted, without change on this question, in 1982. 31 U.S.C. § 3124(a). Within both the ordinary and technical meaning of the language, the certificate clearly states an "obligation," involving the "full faith and credit of the United States" (J.A. 58-59). Indeed, that is the only obligation running to the holder of the certificate, since the certificate expressly states that "This certificate does not constitute a liability of nor evidence any recourse against the issuer." (J.A. 58). Whether Section 742 of Title 31, as written, is too broad, is essentially a political question. The statute can be changed by Congress, where the many competing factors can be appropriately considered. The statutory language seems unusually clear and applicable, and it should not be rewritten by this Court.

6. Further, in claiming that a decision in favor of Appellant would create a large tax shelter, the United States misstates the consequences of such holding to the issuer. Whether or not interest on the certificates is taxable to the holder, the *issuer* will pay the same amount of tax. If the State in question adopted the federal rule, stated in Rev. Rul. 70-545, 1970-2 C.B. 8, the issuer would be treated as a fiduciary and recognize no interest income (though it would of course recognize gain, if any, on the sale of the certificates and income earned from its servicing fees, etc.). This is true

whether or not the interest on the certificates is taxable by the State. Conversely, if the State did not treat the issuer as a trustee, the issuer would presumably recognize interest income on the underlying mortgages to the extent collected from the mortgagors, subject to appropriate deductions. The only parties that would not recognize interest income would be the holders of the certificates, for they are the only ones to whom the United States has pledged its full faith and credit on the GNMA Certificates. Therefore, contrary to the contention of the United States, the State tax treatment of interest payments received by the holders has no bearing on the issuer's tax status. The tax treatment of the issuer turns on State law, and that law will be completely unaffected, with regard to the issuer's tax liability, by whatever decision this Court reaches in this case.

7. Finally, it is simply incorrect to assert that a finding of tax immunity would not advance the purposes of 31 U.S.C. § 742. It is true that the Federal Government would not receive a direct cash benefit, but immunity would certainly promote other valuable government functions, such as improving the nation's housing supply by providing additional mortgage credit, and lowering mortgage interest rates. As discussed previously, such government purposes are just as important as the power to borrow money directly; and use of the Government's credit is equally crucial in either case.

CONCLUSION

The GNMA certificates, as obligations of the United States, are exempt from the Illinois *ad valorem* property tax under both the Constitution and 31 U.S.C. § 742.

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AMICUS CURIAE

BRIEF

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OCTOBER TERM, 1986

ROCKFORD LIFE INSURANCE COMPANY, APPELLANT

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DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS, ET AL.

ON APPEAL FROM THE SUPREME COURT OF ILLINOIS

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING AFFIRMANCE

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QUESTION PRESENTED

Whether mortgage-backed certificates conveying an interest in a pool of mortgages owned by the issuer are exempt from state taxation as "obligations of the United States" under Rev. Stat. § 3701 by virtue of the fact that they are guaranteed by the Government National Mortgage Association.

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ON APPEAL FROM THE SUPREME COURT OF ILLINOIS

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING AFFIRMANCE

INTEREST OF THE UNITED STATES

Section 3701 of the Revised Statutes (1875 ed.), codified in its present form at 31 U.S.C. 3124(a), immunizes "obligations of the United States" from state taxation. The United States has a strong interest in the correct application of this provision. On the one hand, the United States has a financial interest in ensuring that this immunity is not compromised or reduced, a result that could diminish the market value or investment attractiveness of federal obligations. On the other hand, the federal government's interest in its relations with the several states and in the integrity of its fiscal operations is affected if the immunity conferred by Rev. Stat. § 3701 is mistakenly extended so as to inure to the benefit of private persons without securing or enhancing the borrowing power of the United States. Therefore, the United States has an interest here in the question whether Rev. Stat. § 3701 should be applied to invalidate a nondiscriminatory tax imposed by Illinois on the ground of an immunity not claimed by the United States or its agencies – an immunity that would not serve the credit needs of the United States, would inure to the

benefit of private persons, and would needlessly restrict the taxing power of the State of Illinois.

STATEMENT

1. This case concerns the taxability by a state of mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA, popularly known as "Ginnie Mae"). GNMA is a corporation in the Department of Housing and Urban Development (HUD). It was created in 1968 by the partition of the existing Federal National Mortgage Association into two parts—a privately owned corporation, the Federal National Mortgage Association (FNMA, popularly known as "Fannie Mae"), and GNMA, a government-owned corporation. Title VIII of the Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 536 *et seq.*; 12 U.S.C. 1716b, 1717. The predecessor FNMA was created as a body corporate by the Housing Act of 1954, ch. 649, § 201, 68 Stat., 612-613, although the concept of national mortgage associations originated in the National Housing Act of 1934, ch. 847, § 301(a), 48 Stat. 1252. The purposes now sought to be advanced jointly by FNMA and GNMA were originally set forth in Section 201 of the 1954 Act, 68 Stat. 612-613, and have been carried forward today into 12 U.S.C. 1716. Those purposes are to establish secondary market facilities for home mortgages, to provide that the operations thereof should be financed by private capital to the maximum extent feasible, and to authorize facilities to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments.

In 1968, Congress added 12 U.S.C. 1721(g) to the National Housing Act in order to provide a new mechanism for furthering these purposes. Pub. L. No. 90-448, § 804(b), 82 Stat. 542-543. This provision authorizes GNMA, "upon such terms and conditions as it may deem

appropriate, to guarantee the timely payment of principal of and interest on such trust certificates or other securities as shall (i) be issued * * * and (ii) be based on and backed by a pool composed of mortgages which are insured" under various other federal programs. The statute specifies that the pool may contain mortgages insured by the Veterans Administration (VA), by the Federal Housing Administration (FHA), and by the Farmers Home Administration (FmHA). See 12 U.S.C. 1721(g)(1), cross-referring to 38 U.S.C. 1815, 12 U.S.C. 1715*l*, and 42 U.S.C. 1471.

Under Section 1721(g), GNMA is authorized to collect from the issuer of a mortgage-backed certificate a reasonable fee for its guaranty. If "the issuer is unable to make any payment of principal of or interest on any security guaranteed under this subsection," GNMA is to make the payment when due and "thereupon shall be subrogated fully to the rights satisfied by such payment" (12 U.S.C. 1721(g)(1)). The statute also authorizes GNMA to provide by contract with the issuer that, in the event of default by the issuer, the mortgages constituting the pool on which the guaranteed securities were issued should become "the absolute property of [GNMA] subject only to the unsatisfied rights of the holders of the securities based on and backed by" the pool of mortgages (*ibid.*). And the statute provides (*ibid.*) that the "full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty under this subsection."

Pursuant to its rulemaking authority contained in 12 U.S.C. 1723a(a), GNMA has promulgated detailed regulations that govern these mortgage-backed securities. 24 C.F.R. 390.1-390.17. Section 390.1 generally provides that all such transactions are governed by the specific terms of the Mortgage-Backed Securities Guides issued by GNMA and by contracts entered into by the parties. Other regula-

tions specify eligibility requirements for issuers[1] and establish the various obligations of the parties.

The general workings of GNMA-guaranteed certificates based on a mortgage pool can be briefly described as follows. A financial institution assembles a pool of mortgages insured or guaranteed by the FHA, the VA, or another government agency. The financial institution then enters into an agreement with GNMA under which GNMA guarantees timely payment of principal and interest on certificates that will be issued based on the pool of mortgages. The financial institution as issuer then sells the certificates to investors, promising to pay the certificate holders interest and principal. The underlying pool of mortgages is the source for the payments made by the issuer, and the interest rate paid on the certificate is derived from that underlying mortgage pool. In the event that the issuer defaults on the payments, the certificate holders may recover from GNMA, which is empowered to take certain actions against the issuer. See generally *New York Guardian Mortgagee Corp.* v. *Cleland,* 473 F.Supp. 409, 411 (S.D.N.Y. 1979).

More specifically, the regulations provide that two different types of mortgage-backed certificates may be issued. "Straight pass-through securities" provide that the issuer shall pay to the holders a proportionate share of the proceeds of principal and interest from the pool of mortgages, *as collected,* less servicing fees and other specified costs approved by GNMA. "Modified pass-through securities" provide for payment of both specified principal installments and a fixed rate of interest on the unpaid principal balance, *whether or not principal and interest are*

[1] The eligibility requirements are contained in 24 C.F.R. 390.3. Among other requirements, the issuer must be in good standing as a mortgagee approved by the FHA and as a mortgage-servicer approved by FNMA or GNMA; the issuer must maintain the applicable net worth set forth in 24 C.F.R. 390.3(c); and the issuer must meet other conditions prescribed by the GNMA Guide.

collected from the mortgagors, but with all prepayments being passed through to the certificate holder. Thus, in the case of delinquent mortgages in a pool backing "modified pass-through securities," the issuer may be required to make advances to maintain the specified schedule of interest and principal payments to the certificate holders. After a mortgage has been in default for 90 days, however, the issuer may at any time repurchase the defaulted mortgage from the pool for an amount equal to the unpaid principal. See 24 C.F.R. 390.5(a).[2] The Illinois Court of Appeal found (J.A. 32) that "the certificates here are modified pass-through certificates." A representative example of a modified pass-through GNMA Certificate is set forth at J.A. 56-59.

If the issuer defaults—by failing to make payments as due or otherwise failing to abide by its contractual obligations—GNMA is authorized to take action against the issuer. Such action by GNMA may include instituting a claim against the fidelity bond that the issuer is required to post (see 24 C.F.R. 390.11), or extinguishing all interests of the issuer in the pooled mortgages and making the mortgages the absolute property of GNMA, subject only to the unsatisfied rights of the certificate holders. 24 C.F.R. 390.15. The certificate holder's recourse in the event of default is against the GNMA guaranty. GNMA guarantees timely payment, in the case of "modified pass-through securities," of specified principal installments and of a fixed rate of interest on the outstanding principal balance, whether or not principal and interest are actually collected from the mortgagors. 24 C.F.R. 390.13.

[2] The regulations also establish a $250,000 minimum face amount for each issue of securities and provide that the face amount cannot exceed the aggregate unpaid principal balance of the mortgages in the pool. 24 C.F.R. 390.5(b). The minimum face amount of any individual certificate is $25,000. 24 C.F.R. 390.5(c).

2. This case involves application to appellant of the Illinois capital stock tax—an ad valorem property tax—for the year 1978.[3] Appellant had purchased mortgage-backed certificates guaranteed by GNMA, as well as obligations guaranteed by various other federal agencies,[4] and appellant sought to exclude these certificates from the corpus of its property subject to Illinois tax. Appellant asserted that the GNMA-guaranteed certificates, as alleged "obligations of the United States," were exempted from state taxation either by the Constitution directly or by Rev. Stat. § 3701, 31 U.S.C. (1976 ed.) 742 (now codified in slightly different form at 31 U.S.C. 3124(a)).

The Illinois Department of Local Government Affairs and its successor, the Department of Revenue, disagreed with appellant's contention. The Department accordingly assessed appellant's capital stock at a value of $6,937,000, a figure that included the obligations that were claimed to be exempt. This assessment was confirmed on administrative review (J.A. 48-51). Appellant sought judicial review of that determination, and the County Collector brought a separate suit to collect the taxes alleged to be due. The cases were consolidated in the Illinois Circuit Court, which entered judgment against appellant for $723,054 based on the assessment made by the Department of Revenue (J.A. 40-42).

The Illinois Appellate Court affirmed the judgment of the circuit court (J.A. 18-38). Relying heavily on its prior decision in *Montgomery Ward Life Ins. Co.* v. *Department of Local Government Affairs*, 89 Ill. App. 3d 292, 411 N.E.2d 973 (1980), the court analyzed in detail the

[3] The tax has since been repealed, effective January 1, 1979 (J.A. 6).

[4] These included obligations guaranteed by HUD pursuant to 42 U.S.C. (1976 ed.) 3902, obligations guaranteed by the Community Development Corporation pursuant to 42 U.S.C. 4514, and obligations guaranteed by the Secretary of Commerce pursuant to 46 U.S.C. 1273(a).

rights and obligations of the various parties under the GNMA certificates and concluded that the certificates were not "obligations of the United States" within the meaning of Rev. Stat. § 3701 (J.A. 27-38). In particular, the court noted that GNMA was not "primarily liable" for payments on the certificates (*id.* at 32-33) and that the certificates were issued "by private entities" (*id.* at 33).

The Supreme Court of Illinois granted leave to appeal, and it affirmed the appellate court's judgment (J.A. 5-16). The court addressed itself principally to the GNMA-guaranteed certificates, which it found to be the greatest part of appellant's holdings in question (see *id.* at 6).[5] The court focused mainly upon this Court's decision in *Smith* v. *Davis*, 323 U.S. 111 (1944), which held that a debt of the United States owed to a contractor on open account was neither constitutionally immune from state taxation nor exempted by Rev. Stat. § 3701. The court explained that the standards for immunity set forth in *Smith* were not satisfied here, both because "the securities in question do not appear to be related to the government's credit needs" and because the government's undertaking is merely a "guarantee," not a certain obligation to make payments (J.A. 11). The court also rejected appellant's reliance on *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392 (1983), pointing out that the decision in that case was based upon the discriminatory operation of the tax in question, and therefore did not focus on whether Rev. Stat. § 3701 was applicable in the first instance (J.A. 11-13).

[5] In this Court, appellant's challenge is limited to the taxability of the GNMA-guaranteed securities, although appellant states (Br. 2 n.1) that it also disagrees with the decision below with respect to the taxability of the securities guaranteed by other federal agencies.

SUMMARY OF ARGUMENT

Appellant's contention that mortgage-backed securities guaranteed by GNMA are "obligations of the United States" within the meaning of Rev. Stat. § 3701 is devoid of support either in legal authority or in common sense. If accepted, it would significantly extend the scope of that statutory immunity in a manner that would adversely affect state taxing authority and benefit only private parties, not the federal government, which is the intended beneficiary of Section 3701.

The statute evinces no intent on the part of Congress to exempt GNMA-guaranteed certificates from state taxation, and neither GNMA nor HUD has ever taken the position that they are exempt. Nor does the economic reality of the GNMA mortgage pool system suggest that these securities are "obligations of the United States." GNMA's role is simply that of a facilitator – by means of providing a guarantee – of a transaction between private parties. The certificates in question are marketed by the issuing financial institution, which assembles the mortgage pool and collects profits and fees from the investors.

The basic obligations are those of the individual mortgagors whose mortgages comprise the pool. It is their payments of principal and interest, collected and remitted by the issuer, that the certificate holders expect to receive. Moreover, the issuer itself has an undeniable obligation to make timely payments to the certificate holders, and default on that obligation yields numerous adverse consequences to the issuer. This obligation is explicit in the certificate itself (J.A. 56, 57), and the issuer is required to satisfy GNMA that it will discharge this obligation before GNMA will guarantee the certificates. And when one considers that the underlying mortgages are themselves insured by the VA, the FHA, or some other federal agency, GNMA's obligation as guarantor under this system is quite secondary, if not tertiary or even further removed. Appellant's assertion that GNMA is "the only party who bears any obligation to the holders of the GNMA certificates" (Br. 10) is thus multiply and egregiously wrong.

The ramifications of appellant's submission are strikingly broad. Its theory would apparently render all federally-guaranteed obligations exempt from state and local taxation, even though such obligations have been viewed for the past 100 years as not being exempt from state and local taxation. And appellant's conclusion that the certificates at issue here are exempt from state property tax would necessarily impel the conclusion that "the interest thereon" (Rev. Stat. § 3701) is exempt from state income tax. Financial institutions would then be able, for state tax purposes, to convert taxable mortgage interest income into tax-exempt mortgage interest income simply by pooling mortgages and issuing them to investors under cover of a GNMA guaranty. Indeed, appellant's argument logically leads to the conclusion that interest paid on *all* federally-insured home mortgages is exempt from state taxation – a conclusion that could enable banks, for state tax purposes, to transform themselves into essentially tax-exempt institutions. This perverse result demonstrates the unsoundness of appellant's attempted expansion of Rev. Stat. § 3701.

ARGUMENT

MORTGAGE-BACKED SECURITIES GUARANTEED BY GNMA ARE NOT EXEMPT FROM STATE TAXATION AS "OBLIGATIONS OF THE UNITED STATES" WITHIN THE MEANING OF REV. STAT. § 3701

1. There is nothing in the federal statutory scheme that evinces any Congressional intent that mortgage-backed securities guaranteed by GNMA should be treated as exempt from state taxation under Rev. Stat. § 3701. In the same statute that creates the authority for GNMA to

guarantee these securities,[6] Congress has demonstrated that, where there are doubts about whether a particular federal undertaking should be exempt from state taxation, it has the ability to answer those doubts expressly. Thus, with respect to trusts of mortgages or other obligations in which listed departments or agencies of the United States have a financial interest, Congress has provided that "[t]he trust or trusts shall be exempt from all taxation" (12 U.S.C. 1717(c)(2)). And Congress has specifically provided that GNMA itself, as well as its income and assets (except real property), is exempt from state taxation (12 U.S.C. 1723a(c)(2)). In the closely related and quite detailed Section 1721(g) that is at issue here, however, Congress gave no indication of any intent to exempt the GNMA-guaranteed securities from state taxation.

The federal government's administrative practice is fully in accord with the view that these securities are not "obligations of the United States" within the meaning of Rev. Stat. § 3701. Neither GNMA nor its parent Department, HUD, has ever taken the position that these securities are exempt from state taxation. We are informed that, in recent years, the General Counsel of HUD has responded to inquiries regarding the taxability of these securities by referring the questioner to *Smith* v. *Davis*, 323 U.S. 111

[6] We note that appellant repeatedly refers to these securities (see Br. i, 9, 11, 12 n.4, 14, 17, 20) as "bonds" of GNMA. It is difficult to reconcile that terminology with the terms of these modified pass-through certificates (see J.A. 56-59). It is true that GNMA is also authorized to guarantee certain "bond-type" securities, which are governed by the regulations set forth at 24 C.F.R. 390.21-390.33. But these latter securities are not involved here, and they differ from the pass-through certificates in a number of respects. For example, the minimum face amount of "bond-type" securities is $100 million (24 C.F.R. 390.25(b)), which is 400 times that of pass-through certificates. And the regulations contemplate in the case of "bond-type" securities a form of centralized management by a trustee who is subject to government regulation (24 C.F.R. 390.29(a)).

(1944), and to the Illinois decision relied upon by the courts below, *Montgomery Ward Life Ins. Co.* v. *Dep't of Local Government Affairs*, 89 Ill. App. 3d 292, 411 N.E.2d 973 (1980). Both of those decisions *rejected* the taxpayer's claim of immunity from state taxation.

2. Appellant suggests (Br. 14) that the financial institution that issues the mortgage-backed certificate is not really an obligor thereon but is merely a fiduciary that "arranges and facilitates" a transaction for the benefit of the government. The economic reality of the mortgage-backed securities program is precisely the reverse. It is in fact GNMA that acts as a facilitator; its role in these transactions is limited to that of a guarantor assisting the consummation of a transaction between, and for the benefit of, private parties. The governmental purposes served by this program are to establish a secondary market for home mortgages and to assist the financing of home ownership with private capital. The issuance of the mortgage-backed certificates advances these purposes for it is essentially a sale by the issuer to private investors of a beneficial or ownership interest in a portion of the underlying pool of mortgages. This point is illustrated quite clearly in the U.S. Dep't of Housing and Urban Development *Handbook GNMA 5500.1, GNMA I Mortgage-Backed Securities Guide* (1985) at 10-1 [hereinafter *GNMA Guide I*]:

> The issuer is solely responsible for "marketing" its securities issuances. The issuer, on its own, makes all necessary arrangements for the sale of the securities to investors, either directly or through securities brokers or dealers. The issuer also makes all necessary arrangements for its receipt of payment for the securities it issues.

Thus, the direct benefits from the transaction inure to the issuer of the certificate in the form of middleman profits and fees, and to the purchaser of the certificate if it proves to be a good investment. The benefit to the government is

the indirect one of furthering the governmental purpose to enhance the availability of home mortgages by creating a strong secondary mortgage market.

It is true, as appellant notes (Br. 15), that the *GNMA Guide I* (at 9-4, 9-5) requires that the issuer execute an (unrecorded) assignment to GNMA of its right, title, and interest in the pool of mortgages. But this is clearly a security device designed to protect GNMA in its obligation to collect and remit interest and principal from the pooled mortgages to the certificate holders in the event of the issuer's default on its obligation to make payment (see 24 C.F.R. 390.15(b)). The certificate holders are the beneficial owners of the pooled mortgages, and the regulations recognize that, in the event of default by the issuer, GNMA takes over the mortgages subject to "the unsatisfied rights therein of the holders of the securities." Indeed, Section 1721(g) acknowledges the certificate holders' prior beneficial interest when it provides that, after GNMA makes payments to them to correct the default, GNMA "thereupon shall be subrogated fully to the rights satisfied by such payment."

3. Appellant's position is predicated largely on its assertion that "GNMA is the only party bearing any obligation to the holders of the GNMA certificates" (see Br. 10-15). This assertion is erroneous on several counts. First, there can be little doubt that the focal obligations that fuel the entire program are the obligations of the individual mortgagors on the mortgages that comprise the pool. It is their payments of interest and principal that the certificate holders expect to receive, through the conduit of the issuer who is obligated to collect and remit those payments. If those individual obligations to pay interest and principal would not be fulfilled in the vast majority of cases, the secondary market that Congress sought to establish would quickly collapse. Moreover, since all of the pooled mortgages must be guaranteed or insured by certain federal

agencies (for example, by the FHA or the VA), there exist secondary obligations of those federal entities that redound to the benefit of the certificate holders.

At any rate, it cannot be denied that the issuing financial institution has an obligation to make timely payments to the certificate holders. The certificate itself, in the form prescribed by the Guide, states explicitly and in capital letters that the issuer (who signs the form at the bottom) "PROMISES TO PAY" (J.A. 56) and that the issuer "shall pay to the holder, whether or not collected by the issuer, and shall remit [specified] monthly payments * * * " (J.A. 57). Indeed, the regulations provide that GNMA will not guarantee the securities if "the issuer does not satisfactorily provide for * * * [t]imely payment of principal and interest" (24 C.F.R. 390.9). Nor is this an obligation that the issuer can take lightly. If it defaults on its obligation, GNMA can take action against its property (24 C.F.R. 390.15(b)). A defaulting issuer, moreover, will lose the opportunity to earn and collect servicing fees, and both its status as an eligible issuer (24 C.F.R. 390.3) and its ability to provide the requisite fidelity bond (24 C.F.R. 390.11) will be called into serious question. Cf. *GNMA Guide I*, at 6-1 to 6-4.

It is thus sheer sophistry to maintain that the mortgage-backed certificates impose no obligation upon their issuer. While the certificate holders's recourse in the event of default by the issuer is against GNMA as guarantor, that does not negate the existence of an obligation on the part either of the issuer or of the ultimate mortgagor. A mortgage note is no less an obligation of the mortgagor in a case where governing law requires that the mortgagee's sole recourse in the event of default is against the security.

4. In addition to the fact that it makes no common sense, appellant's contention is at odds with well-established precedent of this Court. In *Smith* v. *Davis*, 323 U.S. 111 (1944), the Court rejected the taxpayer's claim

that money owed to him by the United States was an "obligation of the United States" entitled to an exemption from state tax under Rev. Stat. § 3701. The reasons given by the Court there for rejecting the taxpayer's claim are equally applicable here. While GNMA's guarantees may enhance the credit-worthiness of home mortgages on the secondary market, those guarantees are obligations that "the United States does not use or need for credit purposes" (323 U.S. at 117). Nor is GNMA's guaranty itself an "interest-bearing obligation[]" (*id.* at 116). And the obligations that do bear interest—the underlying mortgages in the pool—are not "obligations of the United States" and certainly not obligations "issued pursuant to Congressional authorization" (*ibid.*). Cf. 42 Op. Att'y Gen. 341 (1967) (concluding that FNMA certificates were not "obligations of the United States" for purposes of the debt limit provisions).[7]

5. The broad ramifications of accepting appellant's submission dispel any possible doubt over whether the decision below should be affirmed. If GNMA's guaranty with respect to these mortgage-backed securities suffices to bring them within the umbrella of Rev. Stat. § 3701, it is not apparent why all obligations guaranteed by federal

[7] Appellant's reliance (Br. 22-23) on *Memphis Bank & Trust Co.* v. *Garner*, 459 U.S. 392 (1983), is misplaced. That decision turned on the discriminatory nature of the state tax and, accordingly, did not focus on whether particular obligations were covered by Rev. Stat. § 3701 at all. Most of the obligations involved in that case clearly were "obligations of the United States," and there was no reason for the Court to consider whether certain obligations of Federal Farm Credit Banks also held by the taxpayer were similarly covered by Rev. Stat. § 3701. The Court certainly made no determination on that question. In any event, even if the Court had made such a determination, it would be at best dictum on an issue that was not disputed by the parties, and hence would provide scant assistance to appellant. Finally, the obligations of the Farm Credit Banks bear little resemblance to the mortgage-backed securities involved here.

entities—such as garden-variety home mortgages insured by the VA or the FHA—should not also qualify for exemption from state taxation in the hands of a bank or other investor.[8] This would significantly expand the impact of Rev. Stat. § 3701 on the taxing power of the states, since many agencies of the United States guarantee a great variety of obligations. To the best of our knowledge, none of the myriad of such federal guarantees has heretofore been judged to cause the underlying obligation to be regarded as immune from state taxation, and appellant's submission thus flies in the face of long and consistent practice by all parties to these instruments.[9]

In addition, holding the securities involved here to be tax-exempt would not advance the purposes of Section 3701. If GNMA-guaranteed certificates were immune from state property taxes, those certificates would presumably fetch an enhanced price when marketed. But no benefit from that enhanced price would inure to the federal government; rather, it would inure to the financial institution that issued the certificates. Hence, the purpose of Section 3701—to prevent state taxes from diminishing "the investment attractiveness of obligations issued by the

[8] Appellant does not specifically address this point, but it apparently agrees that all such federally guaranteed obligations should be tax-exempt since it notes its disagreement with the lower courts' rejection of tax-exempt status for the non-GNMA, but otherwise federally-guaranteed, securities held by appellant (Br. 2 n.1).

[9] The general recognition that such federal guarantees should not yield exemption from state taxation appears to date back more than a hundred years. The Act of July 14, 1870, ch. 256, 16 Stat. 272 *et seq.*, provided for the refinancing of the Civil War debt and, at Section 1, for the exemption of the newly authorized obligations from state taxation (see *Smith* v. *Davis*, 323 U.S. at 117 n.7). During its consideration by Congress, Senator Sherman assured the Senate that bonds of the Pacific Railroad, which had been guaranteed by the United States, were not within this statute. Cong. Globe, 41st Cong., 2d Sess. 1591 (1870).

United States in an effort to secure necessary credit" (*Smith* v. *Davis*, 323 U.S. at 117)—is not even remotely implicated here. Appellant endeavors to seize upon a statute enacted for the sole benefit of the United States to secure a benefit exclusively for itself and other private participants in the home mortgage marketplace.[10]

More important, the impact on ad valorem taxes like the Illinois tax involved here would be only the tip of the iceberg if appellant's contention were accepted. If these GNMA-guaranteed certificates are "obligations of the United States" within the meaning of Rev. Stat. § 3701, it necessarily follows that "the interest thereon" would be exempt from state and local income taxation. This would create a tremendous loophole that would adversely affect state tax collections.

The exact size of this loophole, enormous in any event, would depend on whether the federally-guaranteed mortgages comprising the mortgage pool would qualify as "obligations of the United States" under appellant's theory. If one assumes that those underlying mortgages would not so qualify, then the interest on the pooled mortgages would be subject to state income taxation as long as the mortgages were held by the issuer and the certificates had not been issued. As soon as the financial institution issued GNMA-guaranteed certificates representing fractional interests in those pooled mortgages, however, the mortgage interest collected by the issuer and remitted by it to the certificate holders would become exempt from state and local income taxes in their hands. This would enable a financial institution, for state tax purposes, to convert taxable interest income to nontaxable interest income simply by packaging its mortgages for sale to investors.

[10] It should be noted that, even if appellant were correct that the mortgage-backed certificates fall within the tax exemption of Section 3701, it does not follow that appellant is entitled to the tax relief it seeks. The ad valorem tax that Illinois imposed upon the certificates was principally upon the values embodied in the underlying mortgages. Pooling the mortgages and providing a federal guaranty relating to the pool undoubtedly makes them more marketable, but the GNMA guaranty can add only marginally the aggregate of preexisting value, especially in light of the fact that the individual mortgages in the pool were already guaranteed by a federal entity. Thus, it is questionable how much of the Illinois tax can be said to be on the alleged "obligation of the United States," *i.e.*, the GNMA guaranty, rather than on the underlying mortgages.

The loophole would be even more gargantuan if one assumes that the underlying mortgages—which, as we have noted (pages 12-13, *supra*), will invariably be insured by the VA, the FHA, or another federal agency—would themselves be "obligations of the United States," as the logic of appellant's argument suggests that they would be. Under that scenario, financial institutions would not even have to bother packaging their mortgages, accompanied by a GNMA guaranty, for sale to investors. A bank or other financial institution could simply confine its lending activities to FHA-insured or VA-insured home mortgages, thereby rendering *all* of its interest income exempt from state and local taxation. That would be one of the greatest tax shelters of all time, and it seems unlikely that this is what Congress had in mind when it enacted Rev. Stat. § 3701.

The perverse and heretofore-undreamt-of results that would flow from acceptance of appellant's position demonstrate the unsoundness of its theory. This Court should accordingly hold that the GNMA-guaranteed, mortgage-backed certificates involved here are not "obligations of the United States," and hence they are not immune from state and local taxation.

CONCLUSION

The judgment of the Supreme Court of Illinois should be affirmed.

Respectfully submitted.

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AMICUS CURIAE

BRIEF

10

No. 86-251

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

ROCKFORD LIFE INSURANCE COMPANY,
Appellant,
v.

DEPARTMENT OF REVENUE OF THE
STATE OF ILLINOIS, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

BRIEF OF THE NATIONAL GOVERNORS' ASSOCIATION, U.S. CONFERENCE OF MAYORS, COUNCIL OF STATE GOVERNMENTS, NATIONAL ASSOCIATION OF COUNTIES, NATIONAL CONFERENCE OF STATE LEGISLATURES, INTERNATIONAL CITY MANAGEMENT ASSOCIATION, AND NATIONAL LEAGUE OF CITIES AS *AMICI CURIAE* IN SUPPORT OF APPELLEES

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QUESTION PRESENTED

Whether a State may include the value of privately owned and issued mortgage-backed certificates guaranteed by the Government National Mortgage Association in the measure of its ad valorem personal property tax.

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INTEREST OF THE *AMICI CURIAE*

The *amici*, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments.

This case concerns the right of the State of Illinois to impose its ad valorem personal property tax on the value of privately issued and owned mortgage-backed certificates guaranteed by the Government National Mortgage Association (GNMA). The claim that the certificates are

exempt from taxation by States and their political subdivisions has broad implications for the States' ability to raise the revenue required for the performance of their essential functions. Thirty-eight States and the District of Columbia impose an income tax on interest payments received by GNMA certificate holders, and four States include GNMA certificates in their property tax bases.[1]

The power to raise revenue by imposing taxes is the essence of sovereignty. As sovereigns in our constitutional system of government, the States "possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants." *The Federalist* No. 32, at 198 (A. Hamilton) (Mentor ed. 1961). Concededly, that authority is limited by the immunity of federal obligations from state taxation. That immunity, however, should not be stretched to shield obligations of private institutions simply on the basis of a remote, contingent, and unliquidated liability of the federal government. In that context, immunity from state tax affords no protection to the federal government, but serves only to allow the holders of those obligations to avoid paying their fair share of the escalating cost of state and local government services.

Increasingly of late, businesses are seeking shelter from state and local taxation based upon allegations of supposed conflict with tangential federal interests, simply because the taxes may touch areas in which the Constitution grants authority to the federal government; or on inferences from federal laws which bear little or no relationship to the intent of those laws (*e.g., R.J. Reynolds Tobacco Co. v. Durham County, N.C.*, 107 S.Ct. 499

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[1] See Federation of Tax Administrators, *State and Local Taxation of Securities of Federal Government Enterprises*, Research Report No. 118 (publication pending). A copy of a portion of the report, relating to State Taxation of GNMA Certificates, has been lodged with the Clerk and served on the parties. The entire report will be lodged with the Clerk and forwarded to the parties as soon as it is published.

(1986); *Wardair Canada, Inc. v. Florida Dep't of Revenue*, 106 S.Ct. 2369 (1986); *see also Tyler Pipe Industries, Inc. and National Can Corp. v. State of Washington Dep't of Revenue*, Nos. 85-1963, 2006 (*prob. juris. noted*, Oct. 6, 1986)). This Court, consistent with the respect that it traditionally has shown to the States' taxing power, generally has rejected such efforts—refusing to infer, without compelling reason, limitations on the States' sovereign power to raise revenue.

In this case, appellant asserts immunity because of the potential liability of GNMA upon default of the private entities that have issued the securities and compiled the underlying pools of federally insured or guaranteed mortgages. This claim must fail. The GNMA certificate is not a promise by the federal government to pay specific sums at specific times and is not issued to secure credit for the federal government. Congress conceived the GNMA program as a means of stimulating *private* investment in the mortgage market as a *substitute* for direct government funding, and did not provide that GNMA certificates should be exempt from state and local taxation.

Appellant perverts the congressional purpose by characterizing these private investments as obligations of the United States within the meaning of Rev. Stat. § 3701. Moreover, because the characterization is made by private business solely to avoid state tax burdens, and not at all to avoid direct interference with the federal government, appellant's claim distorts the constitutional principle of federal immunity from state taxation. The Constitution does not require the States to confer tax immunity on securities merely because they benefit from federal government assistance to private markets.

Amici submit that the decision of the Illinois Supreme Court is correct. Because this Court's decision will have a direct effect on matters of prime importance to *amici*

and their members, *amici* submit this brief to assist the Court in its resolution of the case.[2]

STATEMENT OF THE CASE AND INTRODUCTION

This is an appeal from the Supreme Court of Illinois' holding that the value of mortgage-backed certificates guaranteed by the Government National Mortgage Association (GNMA) was not constitutionally or statutorily immune from an Illinois personal property tax levied on appellant's capital stock. Resolution of the appeal depends in part on the structure and operation of GNMA's mortgage-backed securities program, which *amici* describe below.

In 1968, Congress partitioned the existing Federal National Mortgage Association (FNMA) into two separate corporations. The existing FNMA was transformed into a "Government-sponsored private corporation" with responsibility for certain secondary market operations authorized by Title III of the National Housing Act, as amended. 12 U.S.C. §§ 1716b, 1717(a)(2). A new Government National Mortgage Association was created as a wholly owned government corporation within the Department of Housing and Urban Development (*ibid.*). In addition to assuming the former FNMA's special assistance and management and liquidating functions (*ibid.*; *see id.* §§ 1720,[3] 1721), GNMA received authority in § 1721(g) to guarantee certain mortgage-backed securities. Congress envisioned this "Mortgage-Backed Securities Program" as a means of attracting private capital into the nation's housing market. *See New York Guardian Mortgagee Corp. v. Cleland*, 473 F. Supp. 409, 411 (S.D.N.Y. 1979). The House and Senate Committees

[2] Pursuant to Rule 36 of the Rules of the Court, the parties have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of the Court.

[3] Section 1720 was repealed prospectively in late 1983. Pub. L. No. 98-181, Title IV, § 483(a), (b), 97 Stat. 1240.

explained that the mortgage-backed securities "could have greater liquidity than the mortgages backing them and can be expected to attract sources of investment funds which do not ordinarily invest in the mortgage market, such as pension funds and retirement funds." H.R. Rep. No. 1585, 90th Cong., 2d Sess. 70; S. Rep. No. 1123, 90th Cong., 2d Sess. 80; GNMA I Mortgage-Backed Securities Guide, GNMA 5500.1 Rev. 6 (hereafter "GNMA Guide"), at 1-1 (1984) ("The Mortgage-Backed Securities Program provides a means for channeling funds from the Nation's securities markets into the housing market.").

Under the program, GNMA guarantees the timely payment of principal and interest on securities issued by FNMA, or by other approved private issuers, that are "based on and backed by a trust or pool composed of mortgages" insured or guaranteed by certain federal agencies. 12 U.S.C. § 1721(g)(1); GNMA Guide, at 1-1 to 1-2. GNMA is required to collect a reasonable fee from the issuer for these guarantees. The "full faith and credit of the United States" stands behind GNMA's guarantees. Upon making any payment, GNMA becomes subrogated to the rights satisfied by its payment. GNMA also is empowered to provide for any "right, title, or interest of the issuer in any mortgage or mortgages constituting the trust or pool" to be extinguished upon the issuer's default. 12 U.S.C. § 1721(g)(1).[4] To facilitate GNMA's assumption of ownership of the mortgages upon such a default, the issuer delivers an assignment of each mortgage, along with the original of each note, to a document custodian "in recordable form but not recorded." GNMA Guide, at 9-4.

The applicable regulations define two types of "pass-through" securities. The issuer must pay the holders of

[4] A 1980 amendment to this section provides that no state, local, or federal law (except a subsequently enacted federal law expressly limiting the action) shall prevent GNMA from enforcing such a provision or assuming ownership of the mortgages. Pub. L. No. 96-399, Title III, § 335, 94 Stat. 1654.

"straight" pass-through securities their proportionate share of the principal and interest *as collected*. The more common "modified" pass-through securities, on the other hand, provide for the issuer to make such payments *whether or not collected*. 24 C.F.R. § 390.5(a) (1986).[5] The securities at issue in this case are of the modified pass-through type. *See* J.A. 56, 57 (Representative GNMA Certificate) ("the issuer shall pay to the holder, whether or not collected by the issuer"); J.A. 32 (Illinois Appellate Court opinion).

The regulations and the GNMA Guide describe in detail the issuer's obligations under the program. A lender who wishes to participate must first secure GNMA's approval to become an issuer. Eligibility requirements for issuers are set forth in 24 C.F.R. § 390.3 (1986) and in the GNMA Guide, at 2-4 to 2-7; to summarize, the issuer must be approved as a mortgagee by the Federal Housing Administration, must be approved as a mortgage servicer by FNMA or GNMA, must satisfy GNMA as to its ability to service mortgage-backed securities, and must meet certain net worth requirements.

An approved issuer must obtain GNMA's commitment to guarantee a security. The issuer next proceeds to originate or acquire the mortgage loans that will make up the pool, and arranges for a dealer to market the securities. GNMA Guide, at 1-3. In addition to providing for a document custodian, the issuer must prepare to "segregate the cash flow from the pooled mortgages by maintaining custodial accounts for principal and interest, taxes and other escrows." *Id.* at 11-5, 8-1, 1-3.

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[5] "In the case of delinquent mortgages in a pool backing modified pass-through securities, the issuer is required to make advances if necessary to maintain the specified schedule of interest and principal payments to the holders, or at its option, at any time 90 days or more after default of any such mortgage, the issuer may repurchase such mortgage for an amount equal to the unpaid principal balance of the mortgage." 24 C.F.R. § 390.5(a) (1986).

GNMA and the issuer then enter into a standard form "Guaranty Agreement" (GNMA Guide, Appendix 19). The Agreement recites that the issuer must: pay GNMA an application fee and a monthly guarantee fee; transfer and assign all of its rights in the mortgages to GNMA; replace any mortgage found to be defective within the first four months, and cure any defect found thereafter (or repurchase the defective mortgage); timely remit all payments to the holders, using its own funds if necessary; maintain the appropriate custodial accounts and accounting records; service the mortgages and pursue collections with due diligence; and maintain fidelity bond coverage acceptable to GNMA to assure faithful performance of its fiduciary responsibilities (see also 24 C.F.R. § 390.11 (1986)).

In the event of the issuer's default, the Agreement further provides, *inter alia*, that the issuer shall forfeit to GNMA all of its rights to funds in the custodial accounts, that the issuer will be liable to GNMA for any excess funds withdrawn from the custodial accounts, and that GNMA may extinguish the issuer's rights in the mortgages and assume ownership thereof, subject only to the unsatisfied rights of the security holders. Articles VI and VII of the Agreement state that the security holders shall have full recourse against GNMA pursuant to its guarantee, and that the securities "shall not constitute any liability of nor evidence any recourse against the Issuer or any of its assets, except in respect to or as against the mortgages pooled hereunder . . . ." The certificate issued to a holder (GNMA Guide, Appendix 39) likewise notes that "this Certificate does not constitute a liability of nor evidence any recourse against the Issuer, since it is based on and backed by the mortgages composing the above-referenced pool, and since recourse may be had to the Government National Mortgage Association in the event of any failure of timely payment . . . ."

As this discussion indicates, the private issuer bears the primary responsibility for payment of principal and interest. The GNMA Guide lists the following as among the risks for which issuers of GNMA securities should be prepared: advances to pay amounts due security holders, interest due security holders but not payable by mortgagors (this situation can arise when a mortgage is prepaid in mid-month), losses associated with foreclosures, responsibility for defective mortgages, pool administration costs, losses not covered by insurance, and losses arising from condemnation or other legal proceedings affecting the secured properties. GNMA Guide, at 4-1 to 4-3.

Of course, the issuer that properly administers and services the mortgage pool should not, except in extraordinary circumstances, sustain significant losses. In addition to a mortgagee's usual remedies, including foreclosure, the issuer can look to the government agency that insured or guaranteed the delinquent mortgage. Still more remote is the possibility that GNMA will sustain a loss. The mortgage-backed securities program was designed and intended to "be fully self-supporting and [to] operate at no cost to the Government." 114 Cong. Rec. 15,236 (1968) (remarks of Sen. Bennett). The issuer's fidelity insurance, placement of funds in custodial accounts, and liability to GNMA for excess withdrawals all protect GNMA against any defalcations by the issuer. The issuer also knows that if it does default, GNMA probably will "terminate [its] authority to administer pools, to utilize commitments already outstanding, and to receive additional commitments." *Id.* at 2-8. If the issuer nevertheless does default, GNMA succeeds to all of its rights. Finally, any losses GNMA incurs on its guarantees should, like the losses of an insurer or surety company, be offset by its revenue from guarantee and application fees.

One additional statutory provision is pertinent here. Title 12 U.S.C. § 1723a(c)(1) exempts from federal,

state, and local taxes (other than nondiscriminatory real property taxes) "[t]he Association, including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income." Neither this section nor any other law, however, specifically provides that GNMA certificates are exempt from state and local taxation.

SUMMARY OF ARGUMENT

Mortgage-backed certificates guaranteed by GNMA do not constitute "other obligations of the United States" within the meaning of Rev. Stat. § 3701. Unlike stocks, bonds, and Treasury notes, GNMA certificates are issued by private rather than governmental institutions. The government's liability on the certificates is neither primary nor definite, but contingent and unliquidated. The liability arises only upon a default by the private issuer, and the mortgage-backed securities program has been structured to minimize the likelihood of such a default and of a net loss to GNMA upon default.

Issuance of a GNMA mortgage-backed certificate does not increase the public debt or secure credit for the government's operations, and does not represent a promise by the federal government to pay specified sums at specified dates. Congress's failure to include GNMA certificates within the Association's express immunity from taxation, together with the many differences between GNMA certificates and instruments that do qualify for immunity under § 3701, militate against finding the GNMA certificates to be exempt.

The exemption conferred by § 3701 is no broader than the constitutional principle that the federal government is immune from state and local taxation. The Court's recent decisions have expressly equated the statutory and constitutional immunities; and there is no logical, historical, or precedential basis for concluding otherwise.

Examination of constitutional precedents thus can help resolve both the constitutional and the statutory chal-

lenges to the Illinois tax on the value of the certificates. Those decisions establish that the States' power to tax should not lightly be restricted and that immunity is appropriate only when state taxation would interfere directly with the functioning of the federal government. Taxation of mortgage-backed certificates guaranteed by GNMA would interfere neither directly nor significantly with the functioning of government. The taxes would be paid by private parties, would have at most an indirect and minimal effect on the public fisc, and would not reduce the safety or liquidity of the securities. While certificate holders no doubt would prefer to receive the windfall of immunity rather than to share the cost of state and local government with holders of other privately issued securities, such a windfall is hardly essential to the vitality of the mortgage-backed securities program.

ARGUMENT

I. GNMA MORTGAGE-BACKED CERTIFICATES ARE NOT IMMUNE FROM STATE TAXATION AS "OTHER OBLIGATIONS OF THE UNITED STATES" WITHIN THE MEANING OF REV. STAT. § 3701.

At the time relevant to this case, Rev. Stat. § 3701, as amended (31 U.S.C. § 742 (1976)), provided as follows:

> All stocks, bonds, Treasury Notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes.[6]

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[6] The introductory phrase "Except as provided by law," which appeared in the unenacted § 742, was not included in Rev. Stat.

This Court's three recent decisions construing § 3701 have focused on issues arising under the second sentence of the statute—the propriety of the State's method of computing the tax and the exception for nondiscriminatory franchise taxes. Thus, in *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), a Tennessee tax on the net earnings of banks defined net earnings to include interest on obligations of the United States and of States other than Tennessee, but to exclude interest on the obligations of Tennessee and its political subdivisions. *Id.* at 393-94 and n.3. The parties stipulated that the bank's tax liability was based entirely on interest earned on various obligations of the United States. *Id.* at 394-95. The Court rejected Tennessee's argument that the tax was permissible as a nondiscriminatory franchise tax, finding instead that the tax discriminated in favor of obligations issued by the State and its political subdivisions and against those of the federal government. *Id.* at 398-99.

The next case, *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), involved a state property tax on bank shares. The value of the shares was determined on the basis of the bank's net assets, without a

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§ 3701 itself. *See American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 864, n.8 (1983).

When Title 31 was enacted into positive law in 1982 "without substantive change" (see Pub. L. No. 97-258, § 4(a), 96 Stat. 1067), § 3701 was recodified as 31 U.S.C. § 3124(a). *See First National Bank of Atlanta v. Bartow County Tax Assessors*, 470 U.S. 583, 585, n.1 (1985). The first sentence of the statute was amended by omitting certain words as "surplus," and replacing others for reasons of "clarity and consistency," so that it now reads: "Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State." H.R. Rep. No. 651, 97th Cong., 2d Sess. 94 (1982), *reprinted in* 3 U.S. Code Cong. & Ad. News 1895, 1988 (1982). Here, as in *First National Bank of Atlanta*, the tax at issue was levied prior to the recodification of § 3701, and "the pre-1982 form of the statute technically controls this case." 470 U.S. at 585 n.1. *See also American Bank & Trust Co.*, 463 U.S. at 859, n.1.

deduction for United States obligations held by the bank. Because the State had taken the federal obligations into account in computing the tax, the Court held that the tax violated § 3701.

Most recently, in *First National Bank of Atlanta v. Bartow County Tax Assessors*, 470 U.S. 583 (1985), the Court analyzed another state property tax on bank shares. The value of the shares was based on the bank's *net worth*, reduced by the percentage of its *assets* attributable to federal obligations. The Court upheld the tax, agreeing with the state court's view that the proportionate deduction "excludes federal obligations from the tax base—net worth—to the extent that they are represented there." *Id.* at 587.

In this case, there is no issue regarding the second sentence of § 3701. All agree that the taxing authorities considered the value of the GNMA certificates held by appellant in assessing its capital stock. The only question is whether those GNMA certificates constitute "other obligations of the United States" within the meaning of the first sentence of the statute.

To answer this question, *amici* believe that it is sufficient to note that the certificates reflect a guarantee by the government corporation of privately issued securities. GNMA did not issue the securities, did not undertake the primary obligation thereon, and did not secure credit for or incur any debt on behalf of the United States by virtue of the securities' issuance. A more detailed inquiry, moreover, confirms that GNMA certificates do not belong in the same category as "stocks, bonds, Treasury Notes, and other obligations of the United States."

A. The Pertinent Precedents Demonstrate That GNMA Certificates Are Not Exempt Under § 3701.

The starting place for analysis of the phrase "other obligations of the United States" in the first sentence of

§ 3701 is *Smith v. Davis*, 323 U.S. 111 (1944). The taxpayers in that case were contractors who claimed the United States owed them money for labor and materials they had furnished to the government. When the taxing authorities sought to impose state and county ad valorem property taxes on this open account, the taxpayers responded that it was immune under § 3701.

The Court rejected this contention. Applying the rule of *ejusdem generis*, the Court held that the words "other obligations of the United States" should be construed "as referring only to obligations or securities of the same type as those specifically enumerated"—stocks, bonds, and Treasury notes. 323 U.S. at 116-17. Noting the congressional intent of preventing taxes "which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit," the Court found it unnecessary to extend the tax exemption to an obligation such as an account payable which does not bear interest and which the United States does not use or need for credit purposes. *Id.* at 117.

The Court also addressed the constitutional aspect of the immunity issue, identifying four characteristics which "in each instance" have characterized credit instrumentalities held to be exempt from intergovernmental taxation:

> (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay.

Id. at 115. These factors are significant here because, as discussed *infra* in Part I.B., the scope of the constitutional exemption and the immunity conferred by § 3701 are indistinguishable.

The analysis in *Smith v. Davis* compels the conclusion that mortgage-backed certificates guaranteed by GNMA are not exempt from state taxation under § 3701. Unlike stocks, bonds, and Treasury notes, the GNMA certificates are issued by private entities, not by GNMA or any other instrumentality of the government. The GNMA certificates do not reflect a promise by the United States to pay a specific sum of money at a specific time. Nor does the federal government use or need the GNMA certificates for credit purposes; the private entity's issuance of a GNMA certificate, even more clearly than the government's purchase of labor and materials on open account, does not increase the national debt (*see* 323 U.S. at 114), and cannot reasonably be viewed as an exercise of the government's borrowing power under Art. I, § 8, cl. 2 of the Constitution.

Whereas on stocks, bonds, and Treasury notes the government is the primary obligor, on GNMA certificates the government acts as guarantor pursuant to a statutory scheme designed to minimize the likelihood of a default by the primary obligor (the private issuer) or of a loss to the government in the event of such a default. In *Smith v. Davis* there was at least a ripe claim against the United States for payment of a sum certain from the public fisc. With respect to a GNMA certificate, on the other hand, the liability of the United States is contingent upon a default by the issuer and cannot be expressed as a definite sum until the default occurs. When the liability arises, moreover, it is accompanied by a transfer of rights that enables the government to shift its liability back to the defaulting mortgagors, insurers/guarantors, and/or issuer.

The States' sovereign power to levy taxes should not be restricted by the expansive reading of § 3701 that appellant urges. As the Court noted in *Smith v. Davis*, "much clearer language evidencing an intent to immunize . . . . is necessary under these circumstances." 323 U.S.

at 117. With respect to GNMAs, such evidence is completely lacking. In fact, Congress specifically considered the question of state and local taxation when it created GNMA. At that time, it amended § 1723a(c), designating the existing provision as subparagraph (1), modifying its language to reflect the new Association's functions, and creating a new subparagraph (2) to provide an analogous exemption for FNMA. Pub. L. No. 90-448, § 802(aa)(1)-(4), 82 Stat. 540. Yet Congress did not exempt GNMA certificates from taxation, choosing instead to immunize only the assets and income of the Association itself.

Appellant's arguments for construing GNMA certificates to be "other obligations of the United States" are strained and unpersuasive. Its principal contention relates to the fact that GNMA is the only entity which the certificate holders can hold liable for nonpayment of principal and interest. The certificate for modified pass-through securities provides, as noted *supra*, that it "does not constitute a liability of nor evidence any recourse against the Issuer . . . ." But appellant misrepresents the operation of the mortgage-backed securities program in asserting that "the issuer's role is confined to servicing the mortgages" (Brief for Appellant at 15), and fails to explain why the holder's ability to prosecute a lawsuit is of controlling significance under § 3701. Indeed, in *Smith v. Davis* (323 U.S. at 116), the Court held that the existence of a legally enforceable claim did not require immunity: "That this asset involves a claim against the federal government is no more fatal to the validity of the tax than the fact that in *James v. Dravo Contracting Co.*, 302 U.S. 134, the tax was levied on the contractor's gross receipts from the United States or the fact that in *Alabama v. King & Boozer*, 314 U.S. 1, the sales tax was placed on the sale of property to a contractor for use in a federal government project."

While the holder's only legal recourse may be against GNMA, it is the issuer that undertakes to make timely

payments of principal and interest. The program's structure, moreover, ensures that the issuer has both the incentive and the wherewithal to avoid a default. A holder's claim against GNMA is thus contingent and uncertain. GNMA does not become indebted to the holder unless and until there is a default; issuance of the security does not itself increase the public debt.[7] Focusing solely on the question of legal recourse would make little sense under these circumstances, particularly since Congress's intent was to provide GNMA with sufficient revenue, and legal recourse of its own, to avoid incurring losses even in the event of a default.[8]

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[7] *Cf. FDIC v. Philadelphia Gear Corp.*, 106 S.Ct. 1931 (1986) (standby letter of credit, because of its contingent nature, is not covered by federal deposit insurance).

[8] Appellant deems it "immaterial" that the United States has chosen to funnel private funds into the mortgage market by way of the GNMA guarantee rather than to borrow money directly and then make that money available to private lenders or homebuyers. In either case, appellant insists, the United States is acting pursuant to constitutional authority and for the same purpose of improving the Nation's housing. Nor is it relevant, appellant continues, that the government has provided an underlying source of funds that normally will be sufficient for payment of the principal and interest. See Brief for Appellant at 18 and n.9.

While appellant may feel comfortable asserting, without any citation of authority, that these distinctions make no difference, *amici* take greater comfort from the fact that Congress thought otherwise. Congress's goal was not to improve "the Nation's housing" by throwing federal money at the housing industry, but to promote greater liquidity in the mortgage market and to attract to that market *private* investors, such as pension funds and retirement funds, which ordinarily would invest instead in the securities market. Congress accomplished this goal by developing a program that would ensure holders of the safety of their investment without necessitating a drain on the public fisc. As discussed *infra*, taxation of GNMA certificates would not interfere directly or significantly with the program that Congress chose to develop.

Appellant nowhere discloses why Congress's power to fund a housing program by borrowing money directly has any bearing on

Appellant relies heavily on this Court's decision in *People ex rel. Bank of New York v. Hoffman* ("*The Banks v. The Mayor*"), 74 U.S. (7 Wall.) 16 (1868), for the proposition that "the States may not impose taxes on any governmental function of the United States, whether or not that function is related to the borrowing power." Brief for Appellant at 21, n.12. The facts of the case, however, do not support that proposition. In *The Banks v. The Mayor*, the federal government issued certificates of indebtedness to creditors in exchange for supplies. These certificates of indebtedness were clearly federal obligations, issued directly by the United States with a promise to pay a specific sum on a definite date. While they may not technically have been issued pursuant to the government's borrowing power, they did reflect a securing of credit and an increase in the public debt. The Court's sensible refusal to hold that "there is a solid distinction between certificates of indebtedness issued for money borrowed and given to creditors, and certificates of indebtedness issued directly to creditors in payment of their demands" (74 U.S. (7 Wall.) at 25), hardly supports appellant's position here. To say that any constitutionally permissible federal undertaking is immune from state and local taxation, regardless of the nexus between the undertaking and the government's credit needs, would do violence both to *Smith v. Davis*'s application of the canon of *ejusdem generis* to § 3701, and to the principle that restrictions on the States' power of taxation should not lightly be inferred. See *Smith v. Davis*, 323 U.S. at 117; *see United States v. New Mexico*, 455 U.S. 720, 737-38 (1982); *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 293 (1976).

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whether GNMA certificates are exempt federal obligations. The federal government can also pay cash for supplies using borrowed funds instead of purchasing goods on open account, yet the Court in *Smith v. Davis* deferred to Congress's choice between these alternatives and rejected the immunity claim.

Appellant likewise purports to find support in 12 U.S.C. § 1723c for its argument that GNMA certificates constitute "other obligations of the United States." Section 1723c provides that all securities issued pursuant to the subchapter on National Mortgage Associations, including appellant's GNMA certificates, "shall, to the same extent as securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, be deemed to be exempt securities within the meaning of laws administered by the Securities and Exchange Commission." According to appellant, this section indicates that Congress considered the mortgage-backed certificates to be obligations of the United States. Brief for Appellant at 12-13, n.5.

That Congress chose to treat GNMA certificates the same as direct federal obligations for purposes of the securities laws, however, proves nothing about the status of the certificates as obligations of the United States within the meaning of § 3701. In fact, the language upon which appellant relies suggests Congress understood that GNMA mortgage-backed securities were different from direct federal obligations. This recognition, coupled with Congress's failure to include GNMA certificates within the immunity from taxation described in § 1723a(c), precludes any inference that Congress thought the GNMA certificates would or should be exempt from state and local taxation.[9]

[9] Appellant's interpretation of § 1723c, moreover, would lead to the conclusion that Congress viewed all securities issued under the subchapter to be immune from state taxation. Inasmuch as securities issued by FNMA under 12 U.S.C. § 1719(b) and (e), for example, must expressly state that they are "not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof other than [FNMA]," this interpretation is questionable at best. *Cf. Farmers & Traders State Bank v. Johnson*, 121 Ill. App. 3d 43, 76 Ill.Dec. 565, 569, 458 N.E.2d 1365, 1369 (4th Dist. 1984).

Appellant also argues that *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983), indicates that the mortgage-backed certificates are exempt under § 3701. As noted earlier, however, the only issue in *Memphis Bank* was whether the tax was permissible as a nondiscriminatory franchise tax within the meaning of the second sentence of § 3701. The parties did not contest the applicability of the first sentence of § 3701, having "stipulated that the amount of tax paid by appellant for the years 1977 and 1978 was based entirely on interest earned on various federal obligations, primarily notes and bills of the United States Treasury and obligations of Federal Credit Banks." 459 U.S. at 394-95. Whether or not the Court in *Memphis Bank* read the parties' stipulation too broadly, as appellant intimates in its brief (at 22, n.13), the Court clearly believed that there was no issue as to whether the holdings were federal obligations, and did not purport to resolve any such issue.

It therefore is not surprising that the Court did not discuss in great detail the factors set forth in *Smith v. Davis* as to what constitutes a federal obligation. The Court's opinions in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), and *First National Bank of Atlanta v. Bartow County Tax Assessors*, 470 U.S. 583 (1985), which, like *Memphis Bank*, concerned only the second sentence of § 3701, similarly had no occasion to apply the *Smith v. Davis* analysis. Nor is it surprising, in light of the stipulation that the taxpayer's holdings were federal obligations within the meaning of § 3701, that the Court did not dwell on the express tax immunity of the obligations of Federal Farm Credit Banks which is set forth in 12 U.S.C. §§ 2055, 2079, and 2134 (1982 & Supp. III 1985). *Memphis Bank*, 459 U.S. at 396, n.5.[10]

[10] Appellant's attempt to squeeze support out of *Memphis Bank* brings to mind the Court's cautionary words in *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940):

In sum, there is no basis for according GNMA mortgage-backed certificates, issued and held by private entities, the immunity from state and local taxation that Rev. Stat. § 3701 conferred on "stocks, bonds, Treasury Notes, and other obligations of the United States." A governmental guarantee of the private issuer's responsibilities, for the purpose of encouraging the flow of private funds into a private market, is hardly akin to a debt instrument issued by the government to obtain credit for its own functions, reflecting a promise by the government (and no other entity) to pay a specified sum at a specified date.

B. The Immunities Conferred By § 3701 And By The Constitution Are The Same.

Contrary to appellant's argument, Rev. Stat. § 3701 does not enlarge upon the constitutional tax immunity of government obligations. Although appellant cites *Smith v. Davis* for the proposition that the statutory immunity is broader than the constitutional doctrine in this regard, the Court's opinion does not support this interpretation. To be sure, *Smith v. Davis* analyzed the constitutional and statutory questions separately. Given the absence of any prior cases discussing the statute, it was necessary for the Court to determine whether the statute might confer immunity even though the Constitution did not. In the course of holding that the taxpayer's open account

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> Ambiguous intimations of general phrases in opinions torn from the significance of concrete circumstances, . . . do not alter the limited nature of the function of this Court when state taxes come before it. . . . We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to summarize.

Because appellant's analysis of *Memphis Bank* derives not from what the Court said, but from implications which supposedly should be drawn from the record and briefs, the argument stands on even shakier ground.

claim was not a federal obligation within the meaning of § 3701, however, the Court did not imply that the statutory test differed from the constitutional rule. A fair reading of the opinion indicates that the Court, after reviewing the statute's language and legislative history, found no evidence of congressional intent to expand upon the constitutional immunity. *See* 323 U.S. at 116-18.

More recently, the Court has expressly equated the statutory and constitutional immunities. In *Memphis Bank*, 459 U.S. at 397, the Court said: "Our decisions have treated [§ 3701] as principally a restatement of the constitutional rule." It then relied upon constitutional precedents in holding that the state tax discriminated against federal obligations in violation of § 3701. *Id.* at 396-98. Similarly, in *First National Bank of Atlanta*, the Court rejected the taxpayer's attempt to distinguish certain decisions, which concerned the constitutionally required immunity rather than the scope of § 3701. After quoting from the opinion in *Memphis Bank*, the Court held that "[t]he 1959 addition to § 3701 did not broaden the scope of the exemption required by § 3701 beyond that mandated by the Constitution. . . . The sparse legislative history of the addition certainly provides no support for the assertion that Congress intended to provide a broader exemption." 470 U.S. at 593-94.

Although *Memphis Bank* and *First National Bank of Atlanta* involved only the second sentence of § 3701, the Court's reasoning is equally applicable to the statute's first sentence. Nothing in the language or legislative history of § 3701 suggests even remotely that Congress intended to bring within the statutory restriction obligations that the States were constitutionally free to tax. Nor is there any logical, historical, or precedential foundation for appellant's position that § 3701 reaches the kind of privately issued, government-guaranteed, mortgage-backed securities at issue here.

II. GNMA MORTGAGE-BACKED CERTIFICATES ARE NOT EXEMPT UNDER THE CONSTITUTIONAL DOCTRINE OF FEDERAL IMMUNITY FROM STATE TAXATION.

Given the paucity of cases discussing what types of instruments constitute "other obligations of the United States" within the meaning of § 3701, and the equivalent nature of the constitutional and statutory immunities, a review of this Court's decisions addressing pertinent aspects of the constitutional issue may be useful. *Amici* begin by noting that appellant's GNMA certificates fail the constitutional test set forth in *Smith v. Davis*. They do not reflect the incurring of debt by the federal government, whether through its borrowing power or otherwise, and do not contain a "binding promise by the United States to pay specified sums at specified dates," 323 U.S. at 115. Appellant fares no better when its immunity claim is examined under the Court's decisions that address more generally the federal government's immunity from state taxation.

As the Court remarked in *Memphis Bank*, "the scope of the Federal Government's constitutional tax immunity has been interpreted more narrowly in recent years." 459 U.S. at 397 n.7. *See United States v. New Mexico*, 455 U.S. 720, 731-36 (1982). This trend began with the Court's decision in *James v. Dravo Contracting Co.*, 302 U.S. 134 (1937), which upheld a state tax on the gross receipts of a contractor which had provided services to the United States. Noting that the incidence of the tax fell upon the private contractor, rather than directly upon the government or the contract, the Court stated:

> "The power to tax is no less essential than the power to borrow money, and, in preserving the latter, it is not necessary to cripple the former by extending the constitutional exemption of taxation to those subjects which fall within the general application of non-discriminatory laws, and where no direct burden is laid upon the governmental instrumentality, and there is only a remote, if any, influence upon the exercise of the functions of government."

Id. at 150, quoting *Willcuts v. Bunn*, 282 U.S. 216, 225 (1931).

The next Term, in *Graves v. New York ex rel. O'Keefe*, 306 U.S. 466 (1939), the Court held that imposition of a state income tax on the salary of an employee of a government corporation was constitutionally permissible. Overruling several earlier decisions, the Court ruled that where the principle of tax immunity "is invoked by the private citizen it tends to operate for his benefit at the expense of the taxing government and without corresponding benefit to the government in whose name the immunity is claimed." *Id.* at 483. The Court noted that the purpose of the constitutional immunity was not to confer benefits on private taxpayers or to enable government "to engage employees at salaries lower than those paid for like services by other employers," but to "prevent undue interference with the one government by imposing on it the tax burdens of the other." *Id.* at 483-84.

More recently, in *United States v. New Mexico*, 455 U.S. 720 (1982). Justice Blackmun's opinion for a unanimous Court upheld a state gross receipts tax and compensating use tax on contractors conducting business within the State with the federal government. Reviewing a long line of precedents, the Court concluded (*id.* at 734-35):

> [I]mmunity may not be conferred simply because the tax has an effect on the United States, or even because the Federal Government shoulders the entire economic burden of the levy. . . . [T]ax immunity is appropriate in only one circumstance: when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity be-

> ing taxed is concerned. This view, we believe, comports with the principal purpose of the immunity doctrine, that of forestalling "clashing sovereignty," *McCulloch v. Maryland*, 4 Wheat., at 430, by preventing the States from laying demands directly on the Federal Government.

Such a narrow approach, the Court continued, "accords with competing constitutional imperatives, by giving full range to each sovereign's taxing authority." *Id.* at 735-36. *See also Washington v. United States*, 460 U.S. 536, 540 (1983).

The import of these decisions for the case at bar, *amici* submit, is two-fold. First, they establish generally that "the States' power to tax can be denied only under 'the clearest constitutional mandate.'" *United States v. New Mexico*, 455 U.S. at 738, quoting *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 293 (1976).

Second, their analysis of when a tax that falls on a private party may be deemed to interfere unconstitutionally with the functioning of the federal government demonstrates the weakness of appellant's claim. The Court's recent decisions have eschewed the "wooden formalism" (*United States v. New Mexico*, 455 U.S. at 737; *see Washington v. United States*, 460 U.S. at 544) of earlier cases which "press[ed] a juristic principle designed for the practical affairs of government to abstract extremes." *New York v. United States*, 326 U.S. 572, 577 (1946) (opinion of Frankfurter, J.). In place of these precedents, which "were increasingly divorced both from the constitutional foundations of the immunity doctrine and from 'the actual workings of our federalism'" (*United States v. New Mexico*, 455 U.S. at 731, quoting *Graves v. New York ex rel. O'Keefe*, 306 U.S. at 490 (Frankfurter, J., concurring)), the Court has returned "to the underlying constitutional principle." *United States v. New Mexico*, 455 U.S. at 733. It therefore has held that immunity is appropriate only "when the taxed en-

tity is 'so intimately connected with the exercise of a power or the performance of a duty' by the Government that taxation of it would be '"a direct interference with the functions of government itself."'" *Id.* at 736, quoting *James v. Dravo Contracting Co.*, 302 U.S. at 157.

The property tax levied upon appellant, as a holder of GNMA certificates, cannot be viewed as such a direct interference. Quite apart from the fact that the Solicitor General has not asserted the need for immunity (*see James v. Dravo Contracting Co.*, 302 U.S. at 158), it is apparent that state taxation would affect the mortgage-backed securities program indirectly and minimally, if at all. Appellant asserts merely that state taxation of the GNMA certificates would result in higher interest rates. But it cites no evidence in the record to support this hypothesis,[11] which, like the argument advanced in *Graves* that state taxation of a federal employee's income would increase the government's labor costs, "cannot be judicially assumed." 306 U.S. at 484, n.4.

More important, the purpose of tax immunity was not to enable government to further essentially private interests such as holding down interest rates on privately issued securities.[12] Congress's goal was to enhance

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[11] Appellant cites instead to testimony that the prices of GNMAs "would have to change" if they did not have "a Government guaranty." Brief for Appellant at 16, n.8. Taxation of the certificates would cause their holders, like the owners of other privately issued obligations, to pay their fair share of the cost of state and local government services. It would not, however, affect the government guarantee or otherwise reduce the safety of the investment.

[12] In *Graves*, where the Court held that the constitutional immunity's purpose was not to enable government to pay lower wages than those paid by private employers (306 U.S. at 483-84), the alleged burden at least related directly to the expenses of government. Here the alleged burden relates to interest rates on the securities, which would affect the public fisc only if GNMA, upon an issuer's default, were to incur a greater interest liability to the holders.

the liquidity of mortgage-backed securities, and to encourage the flow of funds from the securities market into the housing market, by pledging the full faith and credit of the federal government to GNMA's guarantee. There is no indication in the statute or its legislative history that Congress intended to attract private investment by offering certificate holders an exemption from state and local taxation.

The Court's recent decisions consistently have rejected immunity claims premised on clearer and more substantial burdens on the federal government than are present here, requiring instead the kind of direct interference of which the Court spoke in *United States v. New Mexico. See Washington v. United States*; *S.R.A., Inc. v. Minnesota*, 327 U.S. 558, 569-70 (1946); *Alabama v. King & Boozer*, 314 U.S. 1, 8-9 (1941); *Graves v. New York ex rel. O'Keefe*; *James v. Dravo Contracting Co.* There is no reason to believe that state and local taxation of GNMA certificates would bring about such a direct interference with GNMA or the federal policies and programs that it implements.

The States' power to tax GNMA certificates should not be restricted absent a much clearer constitutional mandate than is present here. *See United States v. New Mexico*, 455 U.S. at 738. Moreover, for the same reasons that GNMA certificates fall short of qualifying for constitutional tax immunity, the Court should hold that Congress did not intend such securities to be immune from state taxation under Rev. Stat. § 3701.

CONCLUSION

For the foregoing reasons, this Court should affirm the judgment of the Supreme Court of Illinois.

Respectfully submitted,

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February 11, 1987

AMICUS CURIAE

BRIEF

11

No. 86-251

In The
Supreme Court of the United States
October Term, 1986

Rockford Life Insurance Company,
Appellant,
v.
Department of Revenue of the
State of Illinois, *et al.*,
Appellees.

On Appeal from the Supreme Court of Illinois

BRIEF OF THE CALIFORNIA FRANCHISE TAX BOARD AS *AMICUS CURIAE* IN SUPPORT OF APPELLEE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS

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IN THE

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INTEREST OF *AMICUS CURIAE*

The Franchise Tax Board, pursuant to Rule 36.2 of the Rules of the Supreme Court of the United States, submits this Brief as *Amicus Curiae* in support of Appellee Department of Revenue of the State of Illinois. Consent of the parties has been obtained for the submission of this Brief.

The Franchise Tax Board is an agency of the State of California, organized and existing under and by virtue of Section 15700 *et seq.* of the California Government Code. The Franchise Tax Board is charged by statute with the administration and enforcement of the California Personal Income Tax Law and the California Bank and Corporation Tax Law

(California Revenue and Taxation Code, Sections 17003, 19251, 23031, 26422). The interest of the Franchise Tax Board of the State of California in this case is substantially similar to that of the Department of Revenue of the State of Illinois. The difference lies only in the nature of the specific tax involved.[1]

After initially having determined that interest income from securities guaranteed by the Government National Mortgage Association was tax-exempt, the Franchise Tax Board subsequently became aware of the decision of the Illinois Appellate Court in *Montgomery Ward Life Ins. Co. v. State Department of Local Government*, 89 Ill. App. 3d 292, 411 N.E. 2d 973 (1980). The Franchise Tax Board thereupon reexamined its position to determine whether there was any reason why income derived from securities guaranteed by the Government National Mortgage Association (GNMA) should be exempt from personal income taxation. After considerable research, the Franchise Tax Board concluded that both the decision and the analysis in the *Montgomery Ward* case (*ibid.*) were correct, and officially changed its position to assess as taxable, the income received from these guaranteed securities. Formal notice was given to the Public through a variety of sources, including the media. Two cases sustaining the Franchise Tax Board's determination have subsequently been decided by the Board of Equalization of the State of California (the administrative body which reviews the assessments of the Franchise Tax Board) [2]. These decisions have relied upon *Montgomery Ward (ibid.)* and subsequent related decisions of the Appellate Courts of the State of Illinois.

[1] The Illinois tax herein was a personal property tax levied on capital stock. The California tax effected is a personal income tax.

[2] *In the Matter of the Appeal of John La Montaine*, Cal. St. Bd. of Equal., February 4, 1986; and *In the Matter of the Appeal of Marie Delahunte*, Cal. St. Bd. of Equal., December 3, 1986. As these decisions adopt the reasoning of the Illinois Appellate Court in *Montgomery Ward Life Ins. Co. v. State Department of Local Government*, 89 Ill. App. 3d 292, 411 N.E. 2d 973 (1980), they have not been reproduced for this Court.

As the revenue agency charged with administering the California Personal Income Tax Law (California Revenue and Taxation Code, Section 17001 *et seq.*), the Franchise Tax Board has a vital interest in this case. A decision in favor of Appellant Rockford Life Insurance Company could result in a significant revenue loss to the State of California. The Franchise Tax Board submits this Brief *Amicus Curiae* to inform this Court of the analysis applied in concluding that the income derived from securities guaranteed by GNMA is properly taxable. In so doing, the Franchise Tax Board supports the position of Appellee Department of Revenue of the State of Illinois.

SUMMARY OF ARGUMENT

In 1938, Congress established the Federal National Mortgage Association (FNMA) for the purpose of supplying mortgage credit to assist that segment of the housing market for which conventional financing was not readily available. In 1968, FNMA was split into two distinct entities: a federally chartered corporation owned entirely by private shareholders, which retained the FNMA name; and a new corporation within the Department of Housing and Urban Development (HUD), known as the Government National Mortgage Association (GNMA). GNMA assumed the previous government assistance programs of FNMA; however, in 1970, it brought forth the first mortgage-backed securities program, wherein undivided interests in pools of federally insured mortgages were issued in the form of securities and publicly traded, and GNMA guaranteed the issuer's timely payment of principal and interest to the security holders.

Appellant argues that these mortgage-backed securities are obligations of the Federal Government, and, as a consequence are exempt from State taxation. While it is well settled that essential activities of the Federal Government are immune

from State and local taxation (*M'Culloch v. Maryland*, 4 Wheaton 316 (17 U.S., 1819)), and that states cannot tax obligations issued by the Federal Government as a means of providing revenue or for the payment of its debts (*Hibernia Sav. & L. Soc. v. San Francisco*, 200 U.S. 310, 313 (1906); 31 U.S.C. §3124)); the mortgage-backed securities guaranteed by GNMA do not represent an integral activity of the Federal Government, nor are they obligations of the United States issued for the purpose of providing revenue or paying debts. Therefore, there is no reason that these securities should be exempt from State taxation.

The mortgage-backed securities do not entail a "binding promise by the United States to pay specified sums at specified dates," (*Smith v. Davis*, 323 U.S. 111 (1944)) and cannot be considered obligations of the United States. Since the GNMA guarantee under the mortgage-backed securities program warrants only the *timely* performance of the issuer in conveying payments of private individuals (the mortgagors) to other groups of private individuals (the purchasers of the securities), there is no direct obligation of the United States; and a direct obligation of the Federal Government must be involved before a State need forfeit its right of taxation (see analogous reasoning in *State Bank of Albany v. United States*, 389 F. 2d 85 (C.A. 2, 1968).

Furthermore, because of the number of protective measures which have been established to prevent government funds from ever being reached, any liability of the Federal Government to pay anything from the Treasury under the terms of the GNMA guaranty is so remote and contingent as to be virtually without meaning. In those limited circumstances wherein GNMA actually must make payments on its guaranty, the funds are derived, as intended, from the huge reserves which GNMA has accumulated, and have never come from the United States Treasury. As a consequence of the operation

of the mortgage-backed securities program, there is, in effect, no binding promise of the United States to pay anything at any time; thus the securities are not obligations of the Federal Government.

In addition, while Congress did consider the subject of State and local taxation in detail in reference to GNMA itself, and made clear that it is exempt from all such tax (except the tax on real property), there is nothing to indicate that mortgage-backed securities held by private individuals and corporations should be exempted (see 12 U.S.C. §1723a(c)(1). In the absence of any statutory language exempting these securities from State and local taxation, it must be concluded that Congress did not intend them to be exempt.

ARGUMENT

SECURITIES GUARANTEED BY THE GOVERNMENT NATIONAL MORTGAGE ASSOCIATION ARE NOT EXEMPT FROM STATE TAXATION.

In *M'Culloch v. Maryland*, 4 Wheaton 316 (17 U.S., 1819), this Court first promulgated the principle that essential activities of the Federal Government are immune from State and local taxation. Since *M'Culloch*, this immunity has been qualified to the extent that a nondiscriminatory State tax is valid so long as it is not directly laid on the Federal Government, or unless Congress declares otherwise. (*United States v. County of Fresno* 429 U.S. 452, 460 (1977)). The states still may not tax obligations issued by the Federal Government as a means of providing revenue or for the payment of its debts (*Hibernia Sav. & L. Soc. v. San Francisco*, 200 U.S. 310, 313 (1906)); however, as securities guaranteed by GNMA are not obligations of the United States issued for the purpose of providing revenue or for paying debts, they are not immune from State and local taxation.

I. MORTGAGE-BACKED SECURITIES GUARANTEED BY GNMA ARE NOT OBLIGATIONS OF THE UNITED STATES GOVERNMENT.

In *Smith v. Davis* 323 U.S. 111 (1944), the case most cited in discussions of the instant issue, this Court detailed how a determination could be made as to whether an obligation was that of the United States:

> Such instrumentalities in each instance have been characterized by (1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay. (*Ibid.*, pp. 114–115)

The securities guaranteed by GNMA do not satisfy the above requirements, as they do not entail "a binding promise by the United States to pay specified sums at specified dates."

As Appellant has mischaracterized the operations behind the guaranty, a brief description of how the mortgage-backed securities program functions along with the roles of the participants is provided: [3]

The Issuer. A firm which is an approved mortgagee in good standing with certain specified net worth, assembles a "pool" of federally insured mortgages and applies for approval to become an issuer, and for a commitment of guaranty. Upon approval, the issuer submits documents representing the pooled mortgages to a private financial institution (the Custodian) which maintains possession of the mortgages and related documents. Securities are prepared in accordance with instructions provided by the issuer. Documents that assign the mortgages to GNMA are provided to the Custodian; however, these documents are *not recorded* unless the issuer defaults on

[3] The process described is summarized from materials written by GNMA and from 24 C.F.R. §390.1–390.15.

its obligations and GNMA must take possession of the pool under the terms of its guaranty agreement. The issuer is fully responsible for marketing and administration of the securities, [4] carries out mortgage servicing, prepares periodic reports to GNMA, and receives a monthly service fee based on a percentage of the underlying mortgage rate.

The Custodian. A private financial institution receives documents representing the pooled mortgages from the issuer and maintains possession of the mortgages and related documents during the life of the securities issued. GNMA's transfer agent (Chemical Bank) prepares and delivers the securities for the issuer once approval is obtained. Chemical Bank may also hold the principal, interest, tax and insurance payments received from the mortgagors and forward the amount due (after deduction of the various servicing fees) to the security holders, depending on the particular mortgage-backed securities program involved.

The Security Holder. Purchasers of mortgage-backed securities include savings institutions, commercial banks, pension funds, *etc.* and private individuals. Each month, the security holders receive checks (either from the issuer, as in the GNMA I program; or the custodian, as in GNMA II) for their shares of the principal and interest payments scheduled to be made by the mortgagors of the original housing loans.

GNMA. GNMA approves both the issuer and the pool of federally insured mortgages, then authorizes its transfer agent (Chemical Bank) to prepare securities in accordance with instructions provided by the issuer. GNMA guarantees, with the full faith and credit of the United States Government, the

[4] Under the "straight pass-through" program, the issuer is obligated to pay the holders only to the extent the issuer actually received payment from the mortgagors. Under the "modified pass-through" program, the issuer is obligated to pay the holders according to schedule *regardless* of whether the issuer has received payments from its mortgagors. The issuer then advances the payments from its own funds, and must seek reimbursement through the usual remedies in the event of mortgage default.

timely payment of principal and interest to the registered holders of the securities. For its role as guarantor, GNMA earns a specified fee.

Upon consideration of the operation of the program in its entirety, there is no reason that the mortgage-backed securities and the income therefrom should be exempt from State taxation. The monthly payment of principal and interest originates with the home-owning mortgagors, whose payments are insured by specific government agencies, and forwarded on to the security holders by private financial institutions (either the issuer or Custodian). These securities are clearly not obligations of the government of the United States, because GNMA merely guarantees the issuer's timely payment to the holder, and *not* the payment of principal and interest itself. The ultimate source of those payments will be the mortgagor, the mortgage insurer, and/or the actual property itself.

Appellant argues that because each certificate states it does not "constitute a liability of nor evidence any recourse against the issuer," GNMA is ultimately the obligor. This conclusion is unsupported. As explained in the Certificate, this language merely indicates that the Certificate is actually a nonrecourse note "based on and backed by the aggregate debt of the mortgages" in the pool.

Nor, as Appellant also argues, does the fact that each certificate states that "the full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under this guaranty" make the securities exempt from State taxation. The full faith and credit language refers solely to the guaranty, which warrants only the timely payment of the amounts of principal and interest. This is emphasized by the fact that the certificates state that the guaranty is "subject only to the terms and conditions" of the mortgage-backed securities program. Since the program

warrants only the performance of the issuer in conveying payments of private individuals to other groups of private individuals, no direct obligation of the United States is involved; and a direct government obligation must be involved before a State need forfeit its right of taxation.

In *State Bank of Albany v. United States*, 389 F. 2d 85 (C.A. 2, 1968), the State of New York paid interest on loans while students were in college, and the difference between 3% and the market rate thereafter. The Plaintiff Bank filed for a federal income tax refund on the basis that the interest income was exempt as an obligation of a State or political subdivision (Internal Revenue Code, Section 103). The Court found that the ultimate obligation to pay the principal was that of the *students,* not the State; therefore the interest on the loans was not interest on the obligations of a State. A similar conclusion is even more evident herein, where GNMA does nothing other than stand back and collect fees during the execution of a highly successful program, wherein payments are channeled from one group of private individuals (the mortgagors) to another (the security holders), via conduits of other private groups (the issuers and the private financial institutions). The obligation to pay the principal is that of the *mortgagors,* not the Federal Government.

This lack of obligation on the part of the federal government has been acknowledged by its own secondary mortgage market agencies, including GNMA itself, which issued the following statement as part of what appears to be a release for public information purposes: [5]

> It is important to remember that GNMA neither loans the funds for the underlying mortgages, nor does it issue the

[5] This untitled article was updated November 22, 1983 by Louis C. Gasper, Ph.D, and bears the address of GNMA at that time (*i.e.*, Suite 6100, HUD Building, 451 Seventh Street, S.W., Washington, D.C. 20410)

securities. GNMA's function is limited to acting as a surety for the performance of the security issuer, while the underlying mortgages are insured by other government agencies. The funds are ultimately raised by sale of the securities in the private capital market. (*Ibid.*, p. 3)

In a September 1979 publication entitled "A Guide to Fannie Mae," the Federal National Mortgage Association (FNMA) [6] made the following descriptive statement relative to GNMA:

> The GNMA guaranty is backed by the full faith and credit of the United States. From the viewpoint of the Federal Government, the risk assumed by guaranteeing the securities is incremental. Since the government has already insured or guaranteed the mortgages backing the securities, *its additional guaranty principally covers the timing of the cash flow from mortgages* needed for the timely payment of guaranteed obligations. (*Ibid.* p. 81, emphasis added)

It is readily apparent that the only thing guaranteed by GNMA is timeliness of the payments to the security holders.

Moreover, the activation of the promise of the United States to pay anything is so remote as to make that promise virtually without meaning, since the Federal Government has established the following steps to protect itself from any actual obligation to make payment under the mortgage-backed securities program:

[6] Until 1968, FNMA was the sole agency of the Federal Government which administered a secondary mortgage program. In that year it was split into two separate entities: FNMA and GNMA. There still remains close interaction between the two, and also the related entity, the Federal Home Loan Mortgage Corporation (FHLMC). They are usually referred to by their respective "nicknames:" Fannie Mae, Ginnie Mae, and Freddie Mac.

1) *Before issuance*

(a) Only Federal Housing Administration, Veterans' Administration, and Farmers' Home Administration insured mortgages may be assembled into the mortgage pool.

(b) The firm which becomes the issuer of the securities, must meet stringent requirements for approval, including the possession of a specific net worth.

(c) The issuer must pay to GNMA an application fee, a bonding fee, and possess a liability insurance policy with a specific endorsement to GNMA.

2) *After issuance*

(a) A monthly guaranty fee is paid to GNMA, before payments are made to the security holders.

(b) The issuer is audited frequently, and if there is any indication of trouble, GNMA makes arrangements to find another issuer for that particular pool of mortgages.

3) *In case of default*

(a) If individual mortgagors default, the issuer has recourse to the primary government insurer (*e.g.* FHA) to recover losses while continuing payments to the holders.

(b) Should the issuer itself default, the previously assigned documents are then recorded and GNMA becomes the owner of the mortgage pool (subject only to the unsatisfied rights of the holders of the securities). GNMA then takes immediate steps to take possession and continue the program. (See *Consolidated Mtg. & Finance Corp. v. Landrieu*, 493 F. Supp. 1284 (D.C., 1980)

(c) If there is any gap before GNMA can secure a replacement issuer, the obligations of the primary insuring agencies are still activated. (See *New York Guardian Mortgagee*

Corp. v. Cleland, 473 F. Supp. 422 (S.D.N.Y., 1979).

(d) In the remote possibility that GNMA actually has to make payments from its own sources, these funds are derived from the huge reserves which have accumulated from the application fees, the guaranty fees (which are invested and accrue interest) [7] and the various other insurance provisions which GNMA has imposed upon the issuer (see 1(c), above).

GNMA actually paid, from its own funds, only $163,825.00 in 1985, and $98,532.00 in 1984. These amounts represented "less than .0001 percent of mortgage-backed securities outstanding at fiscal year end." (Annual Report, GNMA 1985)

Furthermore, in the Balance Sheet contained in its 1985 Annual Report, *there is no amount given* (a dash appears) under the section entitled "*Liabilities* of the United States Government."

Therefore, the mortgage-becked securities guaranteed by GNMA are not obligations of the United States Government, as they fail to meet the third criteria in *Smith v. Davis*, 323 U.S. 111 (1944), *supra*, p. 6) — they do not entail "a binding promise of the United States to pay specified sums at specified dates."

II. THE GNMA GUARANTY DOES NOT CONFER IMMUNITY FROM STATE TAXATION UPON MORTGAGE-BACKED SECURITIES.

12 (U.S.C. §1721(g) authorizes GNMA to "guarantee the timely payment of principal and interest" on the mortgage-backed securities. Although this guaranty is backed by the full faith and credit of the United States government, it does not change the character of the security into a tax-exempt obligation of

[7] As part of its Annual Report dated 1985, GNMA listed Retained Earnings of $3,488,000,000.00 in its Balance Sheet.

the United States. The certificate plainly states on its face, in capital letters that the private issuer "PROMISES TO PAY" to the holder a particular amount on a specified date each month. Thus, it is the issuer who is "primarily responsible for making such payments." (*New York Guardian Mortgagee Corp. v. Cleland*, 473 F. Supp 422,435 (S.D.N.Y. 1979) The certificate does not state anywhere that the obligation represented is the direct responsibility of the Federal Government. Instead, it merely indicates that the holder may look to GNMA "in the event of any failure of *timely payment* (emphasis added)." The issuer must pay for the guaranty, and if the issuer does not default (which is usually the case), GNMA actually *makes* money on the transaction by having sold the guaranty, as noted by the huge retained earnings it has amassed. And even if, under some remote possibility, the guarantee is actually activated, the program is entirely self-supporting (see *supra*, p. 12).

The full faith and credit guaranty is the functional equivalent of an advertising claim which makes the securities more attractive in the commercial market. The guaranty does not create a primary obligation of the United States, nor does it change the character of the security from a privately issued commercial paper into a direct and immediate obligation of the United States.

III. NO FEDERAL EXEMPTION SHIELDS GNMA MORTGAGE-BACKED SECURITIES FROM STATE TAXATION.

Appellant Rockford Life Insurance Company relies heavily on 31 U.S.C. §3124 (formerly §742), which states, in relevant part, that "[S]tocks and *obligations of the United States Government* are exempt from taxation by a State or political subdivision of a State (emphasis added)." As shown above, the mortgage-backed securities at issue do not meet the statutory

criteria because they are neither stocks nor obligations of the United States Government. Appellant has not cited a single authority to show that indirect and contingent obligations of the United States are exempt from taxation under the statute. There has been no other specific exemption made by Congress for these securities; indeed, there is every indication that Congress clearly intended that mortgage-backed securities should be subject to State taxation.

Congress did consider the subject of State and local taxation in detail in reference to GNMA itself, and made it clear that GNMA ("the Association") is exempt from all such tax except the tax on real property:

> The Association, including its franchise, capital, reserves, surplus, mortgages or other security holdings, and income, shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority, except that any real property of the Association shall be subject to State, territorial, county, municipal, or local taxation to the same extent according to its value as other real property is taxed. (12 U.S.C. §1723a(c)(1))

While this section clearly exempts GNMA and *its* holdings from State taxation, there is nothing that would indicate that mortgage-backed securities held by private individuals and corporations should be exempted. Indeed, no Congressional expression of tax exemption whatsoever exists in §1721(g), Title 12 of the United States Code, which is the only section authorizing the issuance of mortgage-backed securities guaranteed by GNMA. In the absence of any statutory language anywhere exempting these securities from State taxation, it must be concluded that Congress did not intend them to be exempt.

In fact, in floor debate on what was to become 12 U.S.C. §1721[g], Senator Bennett stated:

> The Government guaranty by GNMA will in a sense be a pass-through of the already existing Government guaranty or insurance of mortgages in the pools to the securities backed by the pools. It will not bring about an increase in the Government's total contingent liability, for the reason that the contingent liability of the Government is incurred at an earlier time when the mortgages are insured or guaranteed. GNMA is authorized to collect a fee for its guaranty, and *it is intended that this program will be fully self-supporting and will operate at no cost to the Government.* (114 Cong. Rec. 15,236 (1968), emphasis added).

This language establishes that Congress believed the mortgage-backed securities program would never call upon Treasury funds, thereby giving no reason to provide an exemption from State taxation.

In addition, the following statement appears in a Prospectus (dated May 25, 1972, at page 6) provided by the Federal Government when one of its own quasi-private agencies, the Federal Home Loan Mortgage Corporation, acted as the issuer of mortgage-backed bonds guaranteed by GNMA:

> The income derived from the Bonds does not have any exemption under the Internal Revenue Code of 1954, as amended. The Bonds are subject to Federal estate and gift taxes. Title III of the National Housing Act does not contain any specific exemption with respect to taxes now or hereafter imposed on the principal of or interest on the Bonds by any State, or any of the possessions of the United States, or by any local taxing authority. It is suggested that purchasers residing in states which impose intangible property or income taxes consult their own tax

advisors as to the status of the Bonds and interest thereon.

Since Title III of the National Housing Act also contains the sections pertaining to the mortgage-backed securities guaranteed by GNMA, the above-quoted passage is highly relevant to all the agencies authorized under the Act, as evidence of the interpretation of these secondary mortgage agencies of the intent of Congress not to exclude these classes of securities from State taxation. If GNMA's guaranty of timely payment of an agency of the Federal Government acting as issuer (in an almost identical transaction, involving bonds backed by mortgages, rather than securities) does not confer exemption from State and local taxation, there is no reason for such an exemption when a private issuer's mortgage pool is guaranteed by GNMA.

CONCLUSION

Mortgage-backed securities guaranteed by the Government National Mortgage Association are not obligations of the United States and are therefore not exempt from State and local taxation. Accordingly, this Court should affirm the decision of the Supreme Court of the State of Illinois.

Respectfully submitted,

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